

"DISCUSSION DRAFT" RELATING TO ESTATE VALUATION FREEZES

HEARING BEFORE THE COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES ONE HUNDRED FIRST CONGRESS SECOND SESSION

APRIL 24, 1990

Serial 101-102

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"DISCUSSION DRAFT" RELATING TO ESTATE VALUATION FREEZES

TUESDAY, APRIL 24, 1990

**HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.***

The committee met, pursuant to call, at 10:35 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle presiding.

[The press release announcing the hearing, a copy of the discussion draft, and a summary explanation of the draft follow:]

FOR IMMEDIATE RELEASE
THURSDAY, MARCH 22, 1990

PRESS RELEASE #28
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH BUILDING
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A PUBLIC HEARING ON A "DISCUSSION DRAFT"
RELATING TO ESTATE VALUATION FREEZES

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a public hearing on a "discussion draft" to modify section 2036(c) of the Internal Revenue Code relating to estate valuation freezes. The hearing will be held on Tuesday, April 24, 1990, beginning at 10:00 a.m. in the Committee's main hearing room, 1100 Longworth House Office Building.

In announcing the hearing, Chairman Rostenkowski stated: "The estate freeze provisions of section 2036(c) were enacted as part of the Omnibus Budget Reconciliation Act of 1987. Congress enacted these provisions to curb abusive avoidance of the Federal estate and gift tax. Since these provisions were enacted, concern has been expressed about their complexity and breadth. Modifications made in the Technical and Miscellaneous Revenue Act of 1988 were intended to address some of these concerns.

"In response to concerns that continue to be expressed about the estate freeze provisions, I am releasing today a discussion draft of a bill, along with a summary explanation of the draft bill, that would replace the current provisions of section 2036(c) with other provisions intended to accomplish similar objectives in a less burdensome and more focused manner. I am releasing this discussion draft and holding this hearing in an effort to begin an informed discussion about possible modifications to section 2036(c) that would address legitimate complaints about the current-law provisions while seeking to preserve the integrity of the Federal estate and gift tax system. At this hearing, the Committee solicits comments from the Administration and the public regarding the discussion draft, as well as about other possible revisions."

Attached is a copy of the summary explanation of the draft bill. Copies of the statutory language are available in 1102 Longworth House Office Building.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriett Lawler or Diane Kirkland [(202) 225-1721] no

later than Wednesday, April 11, 1990, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee [(202) 225-1721].

Persons and organizations having a common position are urged to make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing (see formatting requirements below). This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are required to submit 300 copies of their prepared statements to the Committee office, 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Tuesday, May 8, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 200 additional copies for this purpose to the Committee office, 1102 Longworth House Office Building, before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * *

[COMMITTEE PRINT]
DISCUSSION DRAFT

MARCH 22, 1990

This document is printed for discussion purposes only. It has not been reviewed by the Members of the Committee on Ways and Means.

1 PART _____—PROVISIONS RELATING TO ESTATE

2 FREEZES

3 SEC. _____. REPEAL OF SECTION 2036(c).

4 (a) IN GENERAL.—Section 2036 (relating to transfers
5 with retained life estate) is amended by striking subsection (c)
6 and by redesignating subsection (d) as subsection (c).

7 (b) CONFORMING AMENDMENTS.—

8 (1) Section 2207B is hereby repealed.

9 (2) The table of sections for subchapter C of chap-
10 ter 11 is amended by striking the item relating to sec-
11 tion 2207B.

12 (c) EFFECTIVE DATE.—The amendments made by this
13 section shall apply in the case of property transferred after
14 December 17, 1987.

15 SEC. _____. SPECIAL VALUATION RULES.

16 (a) IN GENERAL.—Subtitle B is amended by adding at
17 the end thereof the following new chapter:

J. 27-862—O—1

1 "CHAPTER 14—SPECIAL VALUATION RULES

"Sec. 2701. Special valuation rules in case of transfers of interests in 10-percent owned entities.

"Sec. 2702. Certain options, etc., disregarded.

"Sec. 2703. Definitions and special rules.

2 "SEC. 2701. SPECIAL VALUATION RULES IN CASE OF TRANS- 3 FERS OF INTERESTS IN 10-PERCENT OWNED 4 ENTITIES.

5 "(a) TRANSFERS OF INTERESTS IN CERTAIN ENTI- 6 TIES.—

7 "(1) IN GENERAL.—Solely for purposes of deter-
8 mining whether a transfer of an interest in a 10-per-
9 cent owned entity to a member of the transferor's
10 family is a gift (and the amount of such gift), the value
11 of any interest in such entity retained by the transferor
12 (or a member of the transferor's family other than the
13 transferee) shall be determined as provided in para-
14 graph (2).

15 "(2) VALUATION OF RETAINED INTERESTS.—

16 "(A) IN GENERAL.—The value of any re-
17 tained interest which is not a right to receive
18 qualified fixed payments and which is not de-
19 scribed in subparagraph (C) shall be treated as
20 being zero.

21 "(B) VALUATION OF QUALIFIED FIXED
22 PAYMENTS.—For purposes of determining the
23 value of the right to receive qualified fixed pay-

1 ments under any instrument, it shall be assumed
2 that—

3 “(i) such qualified fixed payments will
4 be made as provided in such instrument, and

5 “(ii) if such instrument has no fixed ter-
6 mination date, payments under such instru-
7 ment will be made in perpetuity.

8 Clause (ii) shall not apply in the case of an inter-
9 est in a trust.

10 “(C) VALUATION OF CERTAIN OTHER
11 RIGHTS.—The value of the following retained in-
12 terests shall be determined without regard to this
13 section:

14 “(i) Any instrument of the same class as
15 the transferred interest.

16 “(ii) Voting rights.

17 “(iii) Any instrument none of the rights
18 under which have a preference over any
19 rights under the transferred interest.

20 This subparagraph shall not apply in the case of a
21 trust.

22 “(3) MINIMUM VALUATION OF JUNIOR
23 EQUITY.—

24 “(A) IN GENERAL.—The application of para-
25 graph (1) to any transfer of a junior equity inter-

est in a corporation or partnership shall not result in such interest being valued at an amount less than its proportionate share of 20 percent of the sum of—

“(i) the total value of all of the equity interests in such entity, plus

“(ii) the total amount of indebtedness of such entity to the transferor (or a member of the transferor’s family).

“(B) DEFINITIONS.—For purposes of this paragraph—

“(i) JUNIOR EQUITY INTEREST.—The term ‘junior equity interest’ means common stock or, in the case of a partnership, any partnership interest which is not preferential.

“(ii) EQUITY INTEREST.—The term ‘equity interest’ means stock or any interest as a partner, as the case may be.

“(4) SPECIAL RULES FOR TRUSTS.—This subsection shall not apply to any transfer of an interest in a trust if—

“(A) such transfer would not constitute a gift if no consideration were received for such transfer, or

1 “(B) all of the property in such trust consists
2 of a personal residence to be used by persons
3 holding term interests (as defined in section
4 2703(d)(3)) in such trust.

5 “(b) DEFINITION OF QUALIFIED FIXED PAYMENTS.—

6 For purposes of this section—

7 “(1) QUALIFIED FIXED PAYMENT.—

8 “(A) IN GENERAL.—Except as otherwise
9 provided in this subsection, the term ‘qualified
10 fixed payment’ means—

11 “(i) any payment or distribution (other
12 than a dividend) with respect to any interest
13 in the entity to the extent such payment or
14 distribution is fixed as to both amount and
15 time for payment, and

16 “(ii) any dividend payable on a periodic
17 basis under any cumulative preferred stock to
18 the extent such dividend is determined at a
19 fixed rate.

20 “(B) TREATMENT OF VARIABLE RATE PAY-
21 MENTS.—For purposes of subparagraph (A), a
22 payment shall be treated as fixed as to amount or
23 rate if such payment is determined at a rate
24 which bears a fixed relationship to a specified
25 market interest rate.

1 “(C) CERTAIN PAYMENTS NOT QUALI-
2 FIED.—An amount which is payable under any
3 instrument issued by a corporation or partnership
4 and which is subject to a life contingency shall
5 not be treated as a qualified fixed payment.

6 “(2) SPECIAL RULE FOR TRUSTS.—In the case of
7 a trust, the term ‘qualified fixed payment’ means—

8 “(A) any fixed amount which is payable not
9 less frequently than annually,

10 “(B) any amount which is payable not less
11 frequently than annually and is a fixed percentage
12 of the fair market value of the property in the
13 trust (determined annually),

14 “(C) any payment described in paragraph
15 (1)(A)(i) under a debt instrument or a lease, and

16 “(D) any amount payable under a noncontin-
17 gent remainder interest if all of the other interests
18 in the trust consist of interests described in sub-
19 paragraph (A), (B), or (C).

20 “(3) WAIVER OF SPECIAL TREATMENT.—

21 “(A) IN GENERAL.—A transferor may elect
22 with respect to payments under any instrument
23 specified in such election to treat such payments
24 as payments which are not qualified fixed pay-
25 ments.

1 “(B) CONSENT REQUIRED WHERE HOLDER
2 NOT TRANSFEROR.—Payments under any instru-
3 ment held by a member of the transferor’s family
4 shall not be treated as qualified fixed payments
5 unless such member consents to be treated in the
6 same manner as the transferor for purposes of ap-
7 plying subsections (c) and (d) with respect to such
8 instrument.

9 “(C) REVOCATION ONLY WITH CONSENT.—
10 Any election under subparagraph (A) (or consent
11 under subparagraph (B)) may be revoked only
12 with the consent of the Secretary.

13 “(4) ELECTION TO HAVE INTEREST TREATED AS
14 QUALIFIED FIXED PAYMENT.—

15 “(A) IN GENERAL.—A transferor may elect
16 to treat any right described in subparagraph (B)
17 as a right to receive qualified fixed payments, to
18 be paid in the amounts and at the times specified
19 in such election, to the extent the amounts and
20 times so specified are consistent with the underly-
21 ing legal instrument giving rise to such right.

22 “(B) RIGHTS TO WHICH ELECTION APPLI-
23 CABLE.—The election described in subparagraph
24 (A) shall apply only to—

1 “(i) the right to receive a dividend on
2 preferred stock, if the sole reason such right
3 was not otherwise treated as a right to re-
4 ceive a qualified fixed payment was that such
5 dividend was noncumulative, or

6 “(ii) the right to receive any partnership
7 payment, if the sole reason such right was
8 not otherwise treated as a right to receive a
9 qualified fixed payment was that any such
10 payment was contingent on and limited by
11 the income or cash flow of the partnership.

12 “(C) TIME AND MANNER OF ELECTION.—

13 The election described in subparagraph (A) shall
14 be made—

15 “(i) on or before the due date (deter-
16 mined with regard to extensions) for filing a
17 gift tax return for the calendar year in which
18 the transfer is made, and

19 “(ii) in the manner prescribed by the
20 Secretary.

21 “(c) DEEMED GIFTS WHERE QUALIFIED FIXED PAY-
22 MENTS ARE NOT MADE.—

23 “(1) IN GENERAL.—A qualified fixed payment
24 under any specially valued retained interest, to the
25 extent not made before the close of the 3rd calendar

1 year following the calendar year in which such pay-
2 ment was due, shall be treated as a gift made by the
3 transferor on the last day of such 3rd calendar year.

4 “(2) EXCEPTIONS.—Paragraph (1) shall not apply
5 to any payment under any instrument if—

6 “(A) the transferor does not hold such instru-
7 ment as of the close of the 3rd calendar year re-
8 ferred to in paragraph (1), or

9 “(B) such instrument is issued by a corpora-
10 tion or partnership and provides that any qualified
11 fixed payment not timely paid shall bear interest
12 compounded annually from the date such payment
13 was due at a rate not less than the discount rate
14 used in valuing such qualified fixed payment
15 under subsection (a)(2).

16 Subparagraph (B) shall not apply to any payment
17 treated as a qualified fixed payment under subsection
18 (b)(4).

19 “(3) REFUND OR CREDIT IF PAYMENT SUBSE-
20 QUENTLY MADE.—If any portion of a qualified fixed
21 payment is treated as a gift made by the transferor
22 under this subsection and such portion is subsequently
23 paid to the transferor—

24 “(A) any tax paid by the transferor under
25 chapter 12 by reason of such gift shall be treated

1 as a payment of tax under chapter 12 made by
2 the transferor for the calendar year in which such
3 portion is paid, and

4 “(B) such portion shall be excluded from tax-
5 able gifts (and any credit allowable under section
6 2505 by reason of such gift shall be disregarded)
7 for purposes of determining the amount of the tax
8 imposed by this subtitle on transfers (including by
9 reason of death) made by the transferor during the
10 calendar year in which such portion is paid or any
11 subsequent year.

12 “(4) SPECIAL RULES FOR TRUSTS.—In the case
13 of a payment under an interest in a trust—

14 “(A) paragraph (1) shall be applied without
15 regard to the 3-year grace period contained there-
16 in and paragraph (2)(A) shall be applied by taking
17 into account the calendar year in which the pay-
18 ment was due in lieu of the 3rd calendar year
19 after such year, and

20 “(B) any payment made after the close of the
21 calendar year in which it was due and on or
22 before the 65th day of the following year shall be
23 treated as made on the last day of the calendar
24 year in which it was due.

1 “(5) ADJUSTMENT TO SUBSEQUENT VALUATIONS
2 OF INSTRUMENT.—The portion of any qualified fixed
3 payment under any instrument which is treated as a
4 gift by the transferor under this subsection shall be dis-
5 regarded in subsequently determining the value of such
6 instrument for purposes of this subtitle in the case of
7 any transfer of such instrument by such transferor or
8 the death of such transferor.

9 “(d) TREATMENT WHERE SPECIALLY VALUED FIXED
10 PAYMENT RIGHTS TRANSFERRED OR TRANSFEROR
11 DIES.—

12 “(1) TRANSFERS.—If the transferor transfers any
13 specially valued fixed payment rights, the transferor
14 shall be treated as having made a transfer of property
15 by gift (on the date of such transfer) in an amount
16 equal to the excess (if any) of—

17 “(A) the fair market value of such rights as
18 of the time of the transfer determined with regard
19 to the rules of subsection (a)(2)(B), over

20 “(B) the fair market value of such rights de-
21 termined without regard to the rules of subsection
22 (a)(2)(B).

23 “(2) DEATH OF TRANSFEROR.—If any specially
24 valued fixed payment rights are includible in the gross

1 estate of the transferor, the gross estate of such trans-
2 feror shall be increased by the excess (if any) of—

3 “(A) the amount which would be includible
4 in the gross estate of the transferor by reason of
5 such rights if the amount so includible were deter-
6 mined with regard to the rules of subsection
7 (a)(2)(B), over

8 “(B) the amount includible in the gross
9 estate of such transferor by reason of such rights
10 (determined without regard to this paragraph).

11 “(3) EXCEPTION WHERE SPOUSE IS TRANS-
12 Feree.—

13 “(A) LIFETIME TRANSFERS.—Paragraph (1)
14 shall not apply to any transfer to the spouse of
15 the transferor if such transfer does not result in a,
16 taxable gift by reason of—

17 “(i) any deduction allowed under section
18 2523, or

19 “(ii) the consideration for the transfer
20 provided by the spouse.

21 “(B) DEATHTIME TRANSFERS.—Paragraph
22 (2) shall not apply to any rights includible in the
23 gross estate of the transferor if a deduction with
24 respect to such rights is allowable under section
25 2056 or 2106(a)(3).

1 “(C) SPOUSE SUCCEEDS TO TREATMENT OF
2 TRANSFEROR.—In any case to which paragraph
3 (1) or (2) does not apply by reason of this para-
4 graph, the transferee spouse or surviving spouse
5 (as the case may be) shall be treated in the same
6 manner as the transferor in applying this subsec-
7 tion and subsection (c) with respect to the rights
8 involved.

9 “(4) SPECIALLY VALUED FIXED PAYMENT
10 RIGHTS.—For purposes of this subsection, the term
11 ‘specially valued fixed payment right’ means any right
12 to receive qualified fixed payments under a specially
13 valued retained interest; except that such term shall
14 not include the right to receive the portion of any pay-
15 ment previously treated as a gift under subsection, (c).

16 “(5) TRANSFER TO INCLUDE TERMINATION.—
17 For purposes of this subsection, any termination of an
18 interest shall be treated as a transfer and any amount
19 received on such termination shall be taken into ac-
20 count under paragraph (1)(B) whether or not such
21 amount is a qualified fixed payment.

22 “(e) ADJUSTMENT IN VALUE OF OTHER SPECIALLY
23 VALUED RETAINED RIGHTS.—

24 “(1) IN GENERAL.—In the case of any right
25 under a specially valued retained interest other than a

1 right to receive qualified fixed payments, for purposes
2 of—

3 “(A) determining whether any transfer of
4 such right by the transferor is a gift (and the
5 amount of such gift), or

6 “(B) determining the amount includible in
7 the gross estate of the transferor by reason of
8 such right,

9 under regulations prescribed by the Secretary (and sub-
10 ject to such conditions as may be prescribed in such
11 regulations), the amount otherwise treated as the value
12 of such right shall be reduced (but not below zero) by
13 the amount of the increase in any prior taxable gift
14 made by the transferor resulting from such right being
15 valued under subsection (a)(2)(A).

16 “(2) SPECIAL RULE WHERE HOLDER NOT
17 TRANSFEROR.—For purposes of paragraph (1), the
18 term ‘transferor’ includes any member of the transfer-
19 or’s family who held the specially valued retained in-
20 terest on the date of the transfer referred to in subsec-
21 tion (a)(1), except that the amount of the reduction
22 under paragraph (1) shall be determined by reference
23 to the actual transferor’s increase in prior taxable gifts.

24 “(f) TREATMENT WHERE CORPORATION BECOMES
25 INSOLVENT, ETC.—

1 “(1) IN GENERAL.—In the case of any corpora-
2 tion or partnership which is insolvent or subject to a
3 title 11 case—

4 “(A) subsection (a)(2)(B) shall not apply in
5 the case of any transfer of an interest in such
6 entity during the period of insolvency or court ju-
7 risdiction, and

8 “(B) if subsection (a)(2)(B) applied in the
9 case of a prior transfer of an interest in such
10 entity—

11 “(i) subsection (c) shall not apply to any
12 qualified fixed payment to the extent the
13 right to receive such payment is extinguished
14 in the title 11 case,

15 “(ii) in the case of any qualified fixed
16 payment due after the date 3 years before
17 the first day of the period of insolvency or
18 court jurisdiction, subsection (c) shall be ap-
19 plied as if the date on which such payment
20 was due had been extended by the period of
21 insolvency or court jurisdiction, and

22 “(iii) subsection (d) shall not apply to
23 any transfer during the period of insolvency
24 or court jurisdiction (and, if such transfer is
25 to a member of the transferor’s family, such

1 member shall be treated in the same manner
2 as the transferor for purposes of subsections
3 (c), (d), and (e)).

4 "(2) DEFINITIONS.—For purposes of paragraph
5 (1)—

6 "(A) INSOLVENT.—The term 'insolvent' has
7 the meaning given to such term by section
8 108(d)(2); except that liabilities to any person who
9 was a transferor in a transfer to which subsection
10 (a)(2)(B) applied (or a member of such transferor's
11 family) shall not be taken into account.

12 "(B) TITLE 11 CASE.—The term 'title 11
13 case' means any case under title 11, United
14 States Code; except that, for purposes of applying
15 paragraph (1)(B), such term shall not include any
16 case if a principal purpose of commencing such
17 case was the avoidance of any of the provisions of
18 this chapter.

19 "(C) PERIOD OF INSOLVENCY OR COURT JU-
20 RISDICTION.—The term 'period of insolvency or
21 court jurisdiction' means the period during
22 which—

23 "(i) the entity is insolvent, or

24 "(ii) the entity is under the jurisdiction
25 of the court in the title 11 case.

1 "SEC. 2702. CERTAIN OPTIONS, ETC., DISREGARDED.

2 "(a) GENERAL RULE.—For purposes of this subtitle,
3 the value of any property shall be determined without regard
4 to any of the following rights with respect to such property
5 held by a member of the family of the transferor or decedent
6 (as the case may be):

7 "(1) Any option (or agreement) to acquire the
8 property at a price less than the fair market value of
9 such property (determined without regard to the option
10 or agreement) as of the time the option (or rights under
11 the agreement) are exercised.

12 "(2) Any right of first refusal (or similar right)
13 with respect to such property.

14 "(3) Any right to use such property pursuant to a
15 lease.

16 "(b) EXCEPTION FOR CERTAIN OPTIONS, ETC.—Sub-
17 section (a) shall not apply to any option (or agreement) re-
18 ferred to in paragraph (1) thereof if—

19 "(1) the property is sold pursuant to such option
20 or agreement,

21 "(2) the price at which such property is so sold is
22 determined pursuant to a formula which—

23 "(A) was reviewed no more than 3 years
24 before such sale, and

25 "(B) at the time of such review, was reason-
26 ably expected to produce a price which would ap-

1 proximate the fair market value of such property
2 as of the time of such sale, and

3 “(3) such property does not have a readily ascer-
4 tainable market value and such property is not resold
5 before the date 6 months after the date of the death of
6 the decedent (or the transfer in the case of a transfer
7 subject to tax under chapter 12 or 13) to a person not
8 related (within the meaning of section 267) to the de-
9 cedent or transferor (as the case may be).

10 “SEC. 2703. DEFINITIONS AND SPECIAL RULES.

11 “(a) FAMILY.—For purposes of this chapter—

12 “(1) IN GENERAL.—The term ‘family’ means with
13 respect to any individual, such individual’s spouse, any
14 lineal descendant of such individual or of such individ-
15 ual’s spouse, any parent or grandparent of such indi-
16 vidual, and any spouse of any of the foregoing. For
17 purposes of the preceding sentence, a relationship by
18 legal adoption shall be treated as a relationship by
19 blood.

20 “(2) CERTAIN TRANSFEREES TREATED AS
21 FAMILY MEMBERS.—In the case of any transfer of
22 property which would be treated as a gift for purposes
23 of chapter 12 without regard to this chapter, the trans-
24 feree shall be treated as if such transferee were a
25 member of the transferor’s family.

1 “(b) TREATMENT OF INDIRECT HOLDINGS.—For pur-
2 poses of this chapter, an individual shall be treated as holding
3 any right or interest if such right or interest is held indirectly
4 by such person through a corporation, partnership, trust, or
5 other entity. If any individual is treated as holding any right
6 or interest by reason of the preceding sentence, any transfer
7 which results in such right or interest being treated as no
8 longer held by such individual shall be treated as a transfer of
9 such right or interest.

10 “(c) CERTAIN REDEMPTIONS, ETC., TREATED AS
11 TRANSFERS.—For purposes of this subtitle, if—

12 “(1) there is a redemption, recapitalization, contri-
13 bution to capital, or other change in the capital struc-
14 ture of a corporation or partnership, and

15 “(2) such redemption, recapitalization, contribu-
16 tion, or other change has substantially the same effect
17 as a transfer of an interest in such entity by any
18 person to a member of his family (or is part of a series
19 of transactions having such an effect),

20 except as provided in regulations, such redemption, recapital-
21 ization, contribution, or other change shall be treated as a
22 transfer of an interest in such entity.

23 “(d) CERTAIN PROPERTY TREATED AS HELD IN
24 TRUST.—

1 “(1) IN GENERAL.—For purposes of this chapter,
2 the transfer of an interest in property with respect to
3 which there is 1 or more term interests shall be treated
4 as a transfer of an interest in a trust.

5 “(2) JOINT PURCHASES.—If 2 or more members
6 of the same family acquire interests in any property de-
7 scribed in paragraph (1) in the same transaction (or a
8 series of related transactions), the person (or persons)
9 acquiring the term interests in such property shall be
10 treated as having acquired the entire property and then
11 transferred to the other persons the interests acquired
12 by such other persons in the transaction (or series of
13 transactions).

14 “(3) TERM INTEREST.—For purposes of this sub-
15 section, the term ‘term interest’ means—

16 “(A) a life interest in property, or

17 “(B) an interest in property for a term of
18 years.

19 “(4) VALUATION RULE FOR CERTAIN TERM IN-
20 TERESTS.—If the nonexercise of rights under a term
21 interest in tangible property would not have a substan-
22 tial effect on the valuation of the remainder interest in
23 such property—

24 “(A) subparagraph (A) of section 2701(a)(2)
25 shall not apply to such term interest, and

1 “(B) the value of such term interest for pur-
2 poses of applying section 2701(a)(1) shall be the
3 amount which the holder of the term interest es-
4 tablishes as the amount for which such interest
5 could be sold to an unrelated third party.

6 “(e) OTHER DEFINITIONS AND SPECIAL RULES.—For
7 purposes of this chapter—

8 “(1) 10-PERCENT OWNED ENTITY.—

9 “(A) IN GENERAL.—The term ‘10-percent
10 owned entity’ means—

11 “(i) any corporation if 10 percent or
12 more of the value of the stock in such corpo-
13 ration is held (directly or indirectly) by the
14 transferor,

15 “(ii) any partnership if 10 percent or
16 more of the value of the capital or profits in-
17 terest in such partnership is held (directly or
18 indirectly) by the transferor, and

19 “(iii) any trust if 10 percent or more of
20 the value of the beneficial interests in such
21 trust is held (directly or indirectly) by the
22 transferor.

23 For purposes of the preceding sentence, the trans-
24 feror shall be treated as holding any interest in an

1 entity held (directly or indirectly) by any member
2 of the transferor's family.

3 “(B) FAMILY TO INCLUDE SIBLINGS.—
4 Solely for purposes of subparagraph (A), any
5 brother or sister of the transferor and any spouse
6 of a brother or sister of the transferor shall be
7 treated as a member of the transferor's family.

8 “(2) SPECIALLY VALUED RETAINED INTER-
9 EST.—The term ‘specially valued retained interest’
10 means any retained interest if the value of such inter-
11 est was determined under subparagraph (A) or (B) of
12 subsection (a)(2) of section 2701 for purposes of apply-
13 ing section 2701(a)(1) to any transfer.

14 “(3) TREATMENT OF CREDITOR AND LESSOR IN-
15 TERESTS.—Any right to receive payments from a 10-
16 percent owned entity under any indebtedness or lease
17 shall be treated as an interest in such entity.

18 “(4) TREATMENT OF TRANSFERS OF INTERESTS
19 IN PORTION OF TRUST.—In the case of a transfer of
20 an income or remainder interest with respect to a spec-
21 ified portion of the property in a trust, only such por-
22 tion shall be taken into account in applying this chap-
23 ter to such transfer.

1 “(f) REGULATIONS.—The Secretary shall prescribe
2 such regulations as may be appropriate to carry out the pur-
3 poses of this chapter, including—

4 “(1) regulations providing appropriate adjustments
5 in the application of subsections (c) and (d) of section
6 2701 where the transferor holds junior equity interests
7 in the entity,

8 “(2) regulations providing for the proper treat-
9 ment of improvements (or other changes) in the case of
10 property to which subsection (d)(4) of this section ap-
11 plied, and

12 “(3) regulations providing for such reporting re-
13 quirements as may be appropriate to carry out the pur-
14 poses of this chapter.”

15 (b) TECHNICAL AMENDMENT.—Section 1015 (relating
16 to basis of property acquired by gift) is amended by adding at
17 the end thereof the following new subsection:

18 “(f) SPECIAL VALUATION RULES TO APPLY.—The
19 rules of chapter 14 shall apply in determining the fair market
20 value of any property at the time of the gift for purposes of
21 this section.”

22 (c) CLERICAL AMENDMENT.—The table of chapters for
23 subtitle B is amended by adding at the end thereof the follow-
24 ing new item:

“Chapter 14. Special valuation rules.”

1 (d) EFFECTIVE DATE.—The amendments made by this
 2 section shall apply in the case of transfers after
 3 _____.

4 SEC. _____. EXTENSION OF STATUTE OF LIMITATIONS.

5 (a) IN GENERAL.—Subsection (a) of section 6501 (relat-
 6 ing to limitations on assessment and collection) is amended
 7 by adding at the end thereof the following new sentence: "In
 8 the case of any tax imposed by chapter 12 with respect to a
 9 transfer of property the value of which is determined under
 10 section 2701, the preceding sentence shall be applied by sub-
 11 stituting '6 years' for '3 years' the first place it appears."

12 (b) UNLIMITED EXTENSION FOR CERTAIN GIFTS NOT
 13 SHOWN ON RETURN.—Subsection (c) of section 6501 is
 14 amended by adding at the end thereof the following new
 15 paragraph:

16 "(9) GIFT TAX ON CERTAIN GIFTS NOT SHOWN
 17 ON RETURN.—If any gift of property the value of
 18 which is determined under section 2701 is required to
 19 be shown on a return of tax imposed by chapter 12 is
 20 not shown on such return, any tax imposed by chapter
 21 12 on such gift may be assessed, or a proceeding in
 22 court for the collection of such tax may be begun with-
 23 out assessment, at any time. The preceding sentence
 24 shall not apply to any item not shown as a gift on such
 25 return if such item is disclosed in such return, or in a

1 statement attached to the return, in a manner adequate
2 to apprise the Secretary of the nature and amount of
3 such item."

4 (c) TECHNICAL AMENDMENT.—Subsection (d) of sec-
5 tion 6501 is amended by striking "3 years" and inserting "3
6 years (6 years in case of any tax imposed by chapter 12 with
7 respect to a transfer of property the value of which is deter-
8 mined under section 2701)".

9 (d) EFFECTIVE DATE.—The amendments made by this
10 section shall apply to gifts after _____.

SUMMARY OF DISCUSSION DRAFTRepeal of Present Estate Freeze Rules

Section 2036(c) would be repealed retroactively.

Replacement Proposal

The replacement provision targets specific valuation abuses that were of concern in the enactment of section 2036(c). These abuses generally involved overvaluation of retained rights which, in a family context, were unlikely to be exercised. The provision abandons the approach of section 2036(c), which taxes future appreciation in value by including previously transferred property in the transferor's gross estate. Instead, the new provision attempts to value more accurately the various interests at the time of the transfer. No effective date is specified for the provision.

The Basic Rule

The new provision would generally apply to transfers of an interest in a corporation, partnership, or trust to a family member. The rules would not apply if the transferor and his family owned less than 10% of the corporation, partnership, or trust.

In determining whether a gift has been made, and the amount of the gift, the following rights which the transferor (or a member of his family) retained would be valued:

1. Rights to Receive Qualified Fixed Payments.

Rights to receive qualified fixed payments ("QFPs") would be valued as described below. QFPs from a corporation or partnership would include a cumulative preferred dividend (payable on a periodic basis and at a fixed rate), or any other payment or distribution which is fixed both as to time and amount.

For trusts, a QFP would be a fixed amount payable at least annually, an amount payable at least annually which is a fixed percentage of the trust's assets (valued annually), or a non-contingent remainder interest if all the other interests in the trust are QFPs.

QFPs would include payments under a debt instrument or a lease (if fixed as to time and amount). QFPs could have a variable interest rate, if the rate were tied to a specified market rate. Payments (except from a trust) subject to a life contingency would not be QFPs. Employment agreements would not be affected by these rules.

To provide flexibility in structuring transactions, taxpayers could elect to treat certain payments as QFPs.

Specifically, non-cumulative preferred stock dividends, and partnership distributions which are contingent on cash flow or income, could be treated as QFPs.

2. Voting Rights.

Voting rights would be valued without regard to these new rules. Thus, minority discounts and control premiums (where applicable) would not be affected.

3. Rights in Same or Junior Class.

If the transferred interest is of the same class as the interest retained (for example, where common stock is transferred and common stock of the same class retained), these rules would not apply. These rules would also not apply if the retained interest were junior to the transferred interest (for example, where preferred stock is transferred and common stock retained).

No other rights would be given value. This treatment is designed to ensure that discretionary rights which are likely not to be exercised in an arm's length manner cannot be used to understate the value of the property transferred.

How QFPs Are Valued

In valuing QFPs, taxpayers would be allowed two favorable assumptions, which would increase the value of the retained interest (and correspondingly reduce the value of the residual gift): (1) that the QFPs will be paid as provided in the instrument; and (2) that QFPs under instruments without a fixed termination or redemption date will be paid in perpetuity.

Generally, as under present law, QFPs from corporations or partnerships would be valued by determining the value of the income stream, using appropriate market discount rates. Taxpayers would be free to set the rate of the QFP at whatever rate they wished. For example, if preferred stock with a par value of \$1,000 carried an 8% cumulative dividend, and 8% was the appropriate market rate, the value of the stock would be approximately \$1,000 (its par value). On the other hand, the taxpayer could choose a 4% dividend rate, but if the appropriate market rate were 8%, the value of the stock would be less than par value.

In the case of trusts, QFPs would be valued (as under current law) according to the appropriate Treasury tables.

These special rules could not reduce the value of the common stock of a corporation or the non-preferred interests of

a partnership below a minimum value. Thus, the total value of the common stock or non-preferred partnership interests could not be less than 20% of the sum of the total equity in the corporation or partnership and any debt which the corporation or partnership owed to the transferor or members of his family. This minimum value is intended to reflect the "option value" of the right of the common stock or non-preferred interest to future appreciation.

Deemed Gift If QFPs Not Made

When the initial transfer is made, the transferor receives the benefit of a favorable assumption that QFPs will be paid when they are due. The corollary to this favorable assumption is that if a QFP is not paid, the transferor will be treated as making a gift of the unpaid QFP.

To provide maximum flexibility for corporations and partnerships, this "deemed gift" rule does not apply if the QFP is paid within 3 years after the year in which the QFP was due. Trusts are allowed to make QFPs within 65 days after the end of the trust tax year in which the QFP was due. In addition, the "deemed gift" rule will not apply to any QFP payable by a corporation or partnership which is not paid, if the instrument under which the payment is to be made provides that the unpaid QFP will bear compound interest at the discount rate used to determine the value of the initial gift.

To prevent double tax, a QFP which is treated as a deemed gift will not be taken into account in valuing the instrument under which it was payable if the instrument is subsequently transferred. In addition, if a QFP which gave rise to a "deemed gift" is later paid, any gift tax paid on the "deemed gift" would be creditable or refundable.

Dispositions of Interests Valued Under These Special Rules

To prevent double tax, if any rights which were previously valued at zero are later transferred (by gift or upon death), the value of the later transfer will be reduced by the amount by which the original gift had been increased because these rights were valued at zero.

If a right to receive QFPs had previously been valued under these special rules, and that right is later disposed of, there may be an additional deemed gift (or an additional amount included in the transferor's estate). This rule is designed to ensure that valuation assumptions which the transferor used initially are applied consistently in subsequent transfers.

This additional gift would result if (but only if) the value of the transferred QFP rights (at the time of the

transfer) determined under these special valuation rules exceeds the value of the rights determined without regard to these special rules. The amount of the additional gift (or estate inclusion) would be such excess. This rule would not apply to transfers to spouses, and the spouse would be treated as if he or she were the original transferor.

Special Exception for Insolvency and Bankruptcy

In addition to the rule which allows payments of QFPs to be missed if compound interest is provided, there is a special insolvency/bankruptcy exception to the deemed gift rules. For example, the three-year grace period for deemed gifts is extended by the period of insolvency or bankruptcy, QFPs which are discharged in bankruptcy are not treated as deemed gifts, and no deemed gift occurs if the transferor transfers his retained interest during insolvency or bankruptcy (unless the IRS can show tax avoidance motives).

Term Interests

The retention of a term interest (including a life estate) in property would be treated the same as the retention of an interest in trust. For example, if a person owned property and transferred a remainder interest in the property while retaining a term interest, the trust rules would apply. This treatment is to prevent the form of the transfer from determining its tax consequences.

For the same reason, a joint purchase of property would be treated as an acquisition of the entire property by the holder of the term interest, followed by a transfer of the remainder interest. The trust and term interest rules would not apply to transfers of interests in a personal residence to be used by the holder of the term interest.

Another special rule would apply to certain term interests not in trust. The rule would apply if the term interest was not a QFP, and if the term interest was in tangible property where the non-exercise of the term-holder's rights with regard to that property would not substantially affect the value of the property passing to the holder of the remainder interest. In that case, the value of the term interest would not be zero, but instead would be the amount for which the term interest could be sold to an unrelated third party (not determined under the Treasury tables). For example, the rule could apply to the joint purchase of a painting or undeveloped real estate (the value of which primarily reflects future development potential). On the other hand, the rule would not apply to a joint purchase of depletable property.

Options

Options held by family members to purchase property at less than fair market value would be taken into account in valuing the property subject to the option under certain circumstances. The option must be exercised, the property must not have a readily-ascertainable fair market value (such as publicly traded stock), and the property must not be resold by the person exercising the option within six months after the decedent's death.

In addition, the option price would have to be determined under a formula which had been reviewed within three years, and which, at the time of review, was reasonably expected to produce a price approximating fair market value at the time of exercise. The value of property subject to other options, rights of first refusal, and leasehold rights held by family members would be determined without regard to such options or rights.

Special Rules

A person would be treated as owning any right or interest owned indirectly through a corporation, partnership, or trust. In addition, any recapitalization, redemption, or contribution to capital which has the same effect as a transfer will be treated as a transfer except as provided by regulations.

Statute of Limitations

The gift tax statute of limitations is extended from three years to six years for transfers subject to these provisions. The statute of limitations would be unlimited for transfers subject to these rules which are not reported, regardless whether a gift tax return was filed for the year in which the transfer occurred.

Mr. PICKLE. The Chair will ask that all members and our guests please take a seat. The chairman of the full committee, Mr. Rostenkowski, and Mr. Archer are at a meeting at the White House and are expected back within the next 15 to 30 minutes.

In the meanwhile, they have asked us to start the committee hearing. I am going to make an opening statement for Mr. Rostenkowski and recognize other Members for any opening statements they might have.

This is Mr. Rostenkowski's statement. [Reading:]

The Committee on Ways and Means meets this morning to hear testimony regarding a discussion draft of a bill relating to estate freezes. Congress enacted the estate freeze rule, or section 2036(c), as part of the Budget Reconciliation Act of 1987.

The rules were intended to curb abuses of the estate and gift tax system. Since the estate tax freeze rules were enacted, there have been a number of complaints, some of the complaints have concerned technical questions in the Technical and Miscellaneous Revenue Act of 1988.

This committee and the Congress attempted to address many of these questions. Other complaints about the estate freeze rules go to more fundamental, substantive issues as to possible adverse effects on family businesses. On the other hand, tax experts warned that unless there are rules to police the estate freeze area, the Federal estate and gift tax may become a voluntary tax for sophisticated tax planners.

An objective of this hearing is to explore whether there is some middle ground to address legitimate concerns of small family businesses while protecting the integrity of the Federal estate and gift tax system.

In an effort to begin an informed discussion about some possible middle ground, Chairman Rostenkowski has released a discussion draft, which proposes to repeal the present estate freeze rules and substitute a new set of rules designed to address potential abuses.

For the hearing today, we have solicited comments from the administration and the public concerning the discussion draft. We thank them for participating in the hearing today. [Ends reading.]

Also, without objection, Mr. Archer's opening statement will be inserted in the record at this point.

[The statement follows:]

OPENING STATEMENT OF HON. BILL ARCHER

Thank you, Mr. Chairman.

I want to commend you for agreeing to hold this hearing. In placing the "discussion draft" before the Committee, you have taken a very constructive step towards dealing with the perceived problems of Section 2036(c). When I introduced H.R. 60 at the beginning of this Congress, it was with the hope that the bill would promote such a reconsideration.

As we proceed to testimony on the "discussion draft," I would like to set forth some of the considerations I believe should be weighed.

First, I want it to be clearly understood that I am all in favor of preventing real abuses which I understand may have existed in the past. However, I do not believe we should adopt broader anti-abuse rules than are absolutely necessary. It is important to craft anti-abuse rules which do not interfere with normal business transactions, especially in the context of family business. A major criticism of Section 2036(c) is that it went too far in preventing perceived abuses.

Second, the Congress has come under increasing criticism of late for the complexity of tax legislation. We are fortunate to actually have bill language available for our review. I would hope that in considering a substitute for Section 2036(c), we would make every effort to further the goal of simplification.

I appreciate all of the effort our witnesses have put into preparing for today's hearing. I am also grateful for the efforts of others who are not able to testify today but who have participated significantly in the effort to solve the Section 2036(c) problem.

Hopefully, this hearing can set the stage for a responsible, bipartisan solution.

Mr. PICKLE. Now before we proceed, the Chair will recognize Mr. Schulze for an opening statement.

Mr. SCHULZE. Thank you, Mr. Chairman.

I commend our chairman for holding today's hearing. Practically everyone agrees that the backbone of our economy is America's small business. Particularly vital are the millions of family-owned and operated businesses and farms across our Nation.

In 1987 and 1988 Congress enacted restrictions on the transfer of small businesses between family generations. These legislative provisions, which I strongly opposed, now threaten to break the spine of family-owned businesses in America. Too often we are crafting our laws to address the exception rather than the general rule. In other words, to target abuse, we are throwing out the baby with the bath water.

In the case of a family-owned business, I feel we should broaden the general rule to provide that transferring of business to an heir would be tax-free.

I would go as far as to allow the sale of that business and allow a tax-free rolling over if the proceeds are used to purchase another business.

I look forward to today's testimony on what I have heard is a constructive draft proposal. I am interested in its impact on family farms.

In southern Pennsylvania, almost any farm left to an heir must be sold for development because of the estate tax burden. Open space across America is being devoured and developed with each generation. Whether it is a small business or family farm, estate taxes are destroying traditional family businesses in America.

I welcome today's witnesses on this vital economic issue.

Mr. PICKLE. Thank you, Mr. Schulze.

Mr. McGrath, do you have an opening statement?

Mr. McGRATH. I congratulate you for leading this effort to change the provisions of section 2036(c) of the Internal Revenue Code.

At times we are faced with difficult situations in exercising our constitutional obligations to institute revenue bills. The issue before us began as an honest effort to stop tax avoidance.

We now see that our attempt to protect the Federal Treasury has interfered with other legitimate societal goals such as the preservation of family-owned businesses.

Many enterprises adversely affected by current law are essential to the communities throughout our Nation. I hope that this hearing will help the committee to achieve a better balance in the Federal estate tax scheme and I look forward to hearing from the diverse group of witnesses assembled before us this morning.

Thank you, Mr. Chairman.

Mr. PICKLE. Does any other member have a statement to make?

Our first witness, then, this morning will be the Honorable Ken Gideon, the Assistant Secretary for Tax Policy of the U.S. Department of the Treasury.

Mr. Gideon, obviously, this committee has created a lot of attention and we have a lot of interested visitors this morning, which indicates the importance that this subject has for a lot of people.

We are glad to have you here and we will recognize you now as the first witness.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. GIDEON. Mr. Chairman, and members of the committee, I am pleased to have this opportunity to present the views of the administration on proposals to repeal and to replace section 2036(c), relating to estate freeze transactions.

I have a longer written statement, which I would request be incorporated in full in the record and from which I will summarize my oral statement.

Mr. PICKLE. Without objection.

Mr. GIDEON. Estate freezes may be structured in many ways, but they have as their common objective limitation or reduction of the value of a business interest or other property includible in a transferor's estate. I have listed several of the more common transactions in the appendix to my written statement.

The Treasury Department does not object to estate freezes so long as the value of the business or other property for gift tax purposes on the date of transfer is properly measured.

The problem, however, is that during the early 1980's, there was growing use of techniques which allowed taxpayers to pass a significant portion of current value to family members free of transfer tax.

Let me outline some of the techniques that we view as abusive. They typically involve retention by the older generation of discretionary rights, many of which were likely not to be exercised at all in a family context because to do so would have significantly undermined the tax benefits of the freeze.

Nevertheless, planners included many such rights in the retained interest and appraisers assigned value to them on the assumption that the rights would be exercised. This had the effect of minimizing the value of the transferred interest, thereby minimizing the gift tax on transfer.

These discretionary rights would soak up virtually the entire value of the business and for this reason are often referred to as soak-up features.

A common way this was accomplished was by structuring dividend and other income rights in such a way as to pass value to a younger generation. For example, planners often used noncumulative dividends, which if not paid in a particular year, would never have to be paid at all.

Because a decision as to whether or not to pay dividends frequently remained in the control of the older generation, the dividends frequently would not be paid. Despite this, appraisers would

assign substantial value to these dividend rights on the assumption that the dividends would be paid.

The cumulative effect of these valuation techniques was significant undervaluation of the transferred interests. Little or no gift tax would be paid on the transfer even though all future appreciation in the value of the business would inure to these interests.

Section 2036(c) was enacted in 1987 to deal with these abuses. However, section 2036(c) not only reaches valuation abuses, but also pulls future appreciation back into the transferor's estate.

Many have raised serious concerns about this result as well as the uncertain operation of the provision.

While sharing many of these concerns, Mr. Chairman, the Treasury Department is strongly of the view that the abuses which Congress sought to remedy by enactment of section 2036(c) are real, and that simple repeal would invite a return of those same abuses. We, therefore, support repeal of section 2036(c) only if a replacement adequate to prevent valuation abuses is substituted for the repealed provision.

We believe that the discussion draft circulated by the committee prior to these hearings offers a constructive and workable approach for such a replacement.

It eliminates the abuses described above by appropriately valuing the various interests on the date of the freeze transaction and by assuring that the subsequent behavior of the various parties will not undermine that valuation.

At the same time, the draft permits flexibility in intrafamily transfers to the extent consistent with this objective.

The basic mechanism of the draft is straightforward. In valuing a transfer of rights in a business among family members, generally only qualified fixed payment rights, or QFP's, which the transferor retains will be valued. Discretionary rights generally will be disregarded because such soak-up features have so frequently been used in cases of valuation abuse.

QFP's are basically rights to receive specified amounts at specified times such as cumulative dividends on preferred stock. In valuing QFP's, the draft assumes that they will be paid. However, if they are not paid after a 3-year grace period, generally a deemed gift will result.

Finally, a minimum value rule ensures that taxpayers cannot significantly undervalue the transferred interest by providing that appreciating equity such as common stock cannot be valued at less than 20 percent of the total equity of the business. The discussion draft incorporates several rules which are intended to provide relief in specific circumstances, such as insolvency and bankruptcy, to prevent double taxation or to enhance planning flexibility.

The discussion draft also addresses three related concerns. Grantor retained income trusts, known as GRITS, joint purchase transactions in which the transferor purchases a life or term interest while a family member purchases a remainder interest, and buy-sell agreements.

These three transactions present many of the same opportunities for abuse that are present in the corporate and partnership context.

We commend the committee for the substance of the discussion draft. We also commend the process of offering draft statutory language as a focus for public comment.

We at the Treasury have benefited substantially from discussing the draft with interested members of the public and we have received many constructive comments for improvement of the draft.

We are prepared to support modifications that improve the draft in terms of taxpayer flexibility, simplicity of administration and compliance, or that enhance the overall workability of the statutory framework.

My written statement cites a few examples of proposed modifications that we believe should be made.

We will oppose, however, changes which would effectively undermine the premise of the discussion draft, which is the proper valuation of the various interests at the time of transfer.

The Treasury Office of Tax Analysis estimates that repeal of section 2036(c) standing alone would reduce revenues in the period from 1991 through 1995 by \$1.021 billion. OTA estimates that if the discussion draft in its current form were enacted to replace section 2036(c), the net effect on revenues during the same period would be a reduction of \$50 million from current law.

The Treasury Department looks forward to working with the Congress and interested members of the public to develop a fair and workable replacement for section 2036(c).

To retain our support, any proposal must prevent abusive valuations in estate freeze transactions. We are encouraged by the progress thus far.

That concludes my opening statement, Mr. Chairman. I will be happy to answer questions at this time.

[The statement of Mr. Gideon follows:]

For Release Upon Delivery
 Expected at 10:30 a.m., E.D.T.
 April 24, 1990

STATEMENT OF KENNETH W. GIDEON
 ASSISTANT SECRETARY (TAX POLICY)
 DEPARTMENT OF THE TREASURY
 BEFORE THE
 COMMITTEE ON WAYS AND MEANS
 UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on proposals to repeal and to replace section 2036(c), relating to "estate freeze" transactions. In particular, we commend the Committee for circulating the discussion draft of March 22 so that testimony today could focus on specific legislative language.

BACKGROUND

"Estate freezes" may be structured in many ways but all have as their common objective limiting or reducing the value of an interest in a business or other property includible in a transferor's estate. Typically, this is accomplished by having an older-generation transferor retain a non-appreciating interest in a business (e.g., preferred stock or a promissory note) while transferring the equity interest (which will benefit from future appreciation) to a younger-generation transferee.

The Treasury Department does not object to estate freezes so long as the value of the business or other property for gift tax purposes is properly measured. This is because the value of the right to future appreciation will be taken into account in setting the current value of the business or other property. However, during the early 1980s, taxpayers made increasing use of techniques that were designed to value the various interests in a business in a way that effectively eliminated the transfer tax on a significant portion of the fair market value as of the transfer date.

These techniques usually involved retention by the transferor of rights which the transferor had discretion to exercise. In fact, many of these rights were likely not to be exercised at all in the family context since their exercise would undermine the transfer tax benefits of the freeze transaction, if not undo the freeze completely. However, because fair market value must normally be determined for transfer tax purposes according to what a willing buyer would pay a willing seller, these rights were assigned value by appraisers on the assumption that they would be exercised as if held by an unrelated third party. This encouraged planners to include as many of these rights as possible in the retained interest in order to maximize the value of the retained interest and minimize the value of the transferred interest. This, in turn, minimized the gift tax consequences of the

¹ Illustrations of a variety of freeze transactions appear in the Appendix.

transfer. Thus, virtually the entire value of the business would be "soaked up" by the discretionary rights retained by the transferor. For this reason, these features are often referred to as "soak-up features."

One of the common ways in which this "soak up" was accomplished was by structuring the right to receive income or cash flow (e.g., dividends on preferred stock) so that value could easily be passed to the younger generation. For example, planners often structured corporate freezes so that the dividend right on preferred stock was "noncumulative." This means that if dividends were not paid in a particular year, there would be no continuing obligation on the part of the corporation to pay those dividends in a later year. Because the decision whether or not to pay dividends often remained in the control of the older generation after the freeze, the dividends frequently would not be paid at all. These passed dividends would not be included in the transferor's estate, but would stay in the corporation, thereby increasing the value of the common stock held by the younger generation, often without payment of gift tax. Appraisals of the preferred stock for gift tax purposes, however, generally assigned substantial value to the right to receive noncumulative dividends, notwithstanding the likelihood of non-payment in a family context.

The cumulative effect of these valuation techniques was the assignment of virtually the entire value of the business to the retained interest for gift tax purposes, resulting in significant understatement of the value of the transferred interest. When the transferred interest was assigned to the younger generation, little or no transfer tax would be due, even though all future appreciation in the value of the business would inure to the transferred interest. Soak-up features retained by the transferor often escaped transfer tax because of lifetime events, expiration at death, or inconsistent valuation for estate and gift tax purposes. The Internal Revenue Service and the Treasury Department consider such techniques to be abusive.

SECTION 2036(c)

In order to deal with these abuses, Congress enacted section 2036(c) in 1987.² Under section 2036(c), the entire value of an enterprise is included in a transferor's estate (or treated as a deemed gift) if the transferor transfers a disproportionately large share of the potential appreciation in the enterprise while retaining an interest in the income of, or rights in, the enterprise. By treating a freeze transaction as a transfer with a retained interest, section 2036(c) therefore reaches not only valuation abuses but also includes future appreciation in the transferor's estate. Serious concerns have been raised about the possible overbreadth of this result, as well as about the uncertain operation of the section.³

² Section 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), and was amended in the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647).

³ The Internal Revenue Service issued Notice 89-99 to provide guidance as to how the Service would interpret section 2036(c). This notice has allayed some of the concerns about how the section will be administered. However, the notice does not address all the underlying concerns about the potential scope of the section, which can be addressed only through legislation.

While sharing many of these concerns, the Treasury Department is strongly of the view that the abuses which Congress sought to remedy by enactment of section 2036(c) are real and that simple repeal would invite the return of those abuses. We therefore support repeal of section 2036(c) today only if a replacement adequate to prevent valuation abuses is substituted for the repealed provision.

DISCUSSION DRAFT

We believe the standard by which a replacement should be judged is whether or not it eliminates the abuses described above while permitting flexibility in intra-family transfers consistent with this objective. Stated another way, does the discussion draft (or any other proposed replacement for section 2036(c)) result in the various interests being valued appropriately on the date of the freeze transaction, and does it assure that the subsequent behavior of the various parties will not cause that value, once determined, to be undermined? Judged by that standard, we believe that the discussion draft circulated by the Committee prior to this hearing offers a constructive and workable approach for such a replacement.⁴

The basic mechanism of the draft is straightforward. In valuing a transfer of rights in a business among family members, generally only rights retained by the transferor which are "qualified fixed payment rights" ("QFP") will be valued. Discretionary rights such as put or call options or noncumulative preferred dividends generally will be disregarded, because such "soak-up features" have so frequently been used in cases of valuation abuse.

QFPs are essentially rights to receive payments in specified amounts at specified times.⁵ Qualified fixed payment rights are assumed to be paid on schedule for valuation purposes. If they are not, the transferor is considered to have made a "deemed gift" in the amount of the missed payment.

Finally, a minimum valuation rule ensures that the appreciating equity interest (such as the common stock or a non-preferred partnership interest) cannot be valued at less than 20 percent of the total equity in the business, which for this purpose includes debt owed to the transferor.

Thus, the discussion draft attempts to deal with the abuses which existed prior to enactment of section 2036(c) in the following ways:

- o Discretionary rights (i.e., soak-up features) generally are not given value in intra-family transfers.

⁴ Congress could also require inclusion of gift tax paid in the transfer tax base (as is already the case for estate tax purposes), thereby eliminating a substantial advantage of inter vivos transfers over testamentary transfers. This would, in turn, eliminate a significant incentive for freeze transactions.

⁵ Generally, the valuation of the right to receive QFPs, such as guaranteed payments from a partnership, will be made using the standard technique of discounting the payment or payment stream to present value, using the market rate of interest or return appropriate for the particular business. Transferors would be free to set the interest or dividend rate at whatever rate they choose, including variable interest rates, recognizing that if the rate selected is below the market rate for that business, the value of the QFP right will necessarily be lower as a result.

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- o Rights to receive QFPs, such as fixed principal and interest payments on a note, are given value based on the assumption that they will be paid. However, if they are not paid, a deemed gift will result.
- o The minimum value rule prevents taxpayers from undervaluing the transferred interest, thus ensuring that the right to future appreciation is appropriately taken into account.

In addition, the discussion draft contains certain other rules intended to prevent these basic rules from operating inappropriately:

- o Explicit rules are included to prevent the same value from being taxed twice for estate and gift tax purposes.
- o Transferors may elect to apply the QFP rule to transactions which would not otherwise qualify (such as noncumulative preferred stock or real estate partnerships in which payments are dependent on income or cash flow) to provide flexibility in structuring transactions.
- o The deemed gift rule provides a three-year grace period for corporations and partnerships so that the failure to make QFPs due to temporary cash flow difficulties will not trigger a gift.
- o No deemed gift will occur in any event if the QFP right provides for compound interest and the fully compounded amount is accounted for when the retained interest is transferred.
- o Special rules are provided to mitigate the deemed gift rule if a corporation or partnership that fails to make QFPs is insolvent or bankrupt.
- o The draft does not change the treatment of minority discounts; voting rights will continue to be valued as under current law.
- o The discussion draft would not apply to transfers of the same class of stock which the transferor retains, nor would it apply to transfers of interests none of the rights of which are junior to the retained interest.
- o Explicit exemptions are provided for personal residences.

The discussion draft also addresses three related problems: trusts in which the transferor has retained an interest, joint purchase transactions in which the transferor purchases a life or term interest while a family member purchases a remainder interest, and buy-sell agreements.

The primary focus of the trust rule is the grantor-retained income trust ("GRIT"). A GRIT is a trust in which the transferor has retained an income interest for a term of years, while transferring the remainder interest to another person (usually a family member). The various interests in a GRIT are valued according to tables published by the Internal Revenue Service which assume a rate of return specified by statute.⁶ Frequently, however, the property placed in a GRIT either does not generate any income or does not generate income equal to

⁶ See IRC Section 7520.

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the rate of return assumed in these tables. This means that the interest transferred to the younger generation remainderman will have been undervalued, which in turn means that the gift tax paid will have been too low.

Consistent with the approach for corporations and partnerships, the only interest in such a trust that is assigned value for gift tax purposes is a QFP. In the trust context, a QFP is generally defined as the right to receive a fixed annual payment or an annual payment based on the value of the assets in the trust (determined annually).⁷ If the trust fails to pay out the required amount, the transferor is treated as having made a deemed gift (just as the failure by a corporation or partnership to make a QFP is treated as a deemed gift).

The discussion draft also applies to certain joint purchases of property. A joint purchase can be structured to work the same way as a GRIT. Joint purchases subject to the rule are purchases of a life or term interest by one family member and the purchase of the remainder interest by another. The discussion draft therefore does not apply where the family members purchase property either as tenants in common or as joint tenants with right of survivorship.

The discussion draft generally treats these joint purchases in the same way it treats GRITs. Thus, only rights to receive QFPs are valued, and failure to make the required payments results in a deemed gift.

The draft also contains a provision concerning buy-sell agreements. Although buy-sell agreements are widely used in closely held businesses and often have legitimate non-tax purposes, they also have potential for suppressing the value of a business interest for transfer tax purposes. The discussion draft requires that, in order for buy-sell arrangements to be taken into account in determining the value of the business interest for estate or gift tax purposes, the buy-sell arrangement must meet certain conditions. These conditions include: (1) the business interest must actually be sold pursuant to the buy-sell arrangement; (2) the purchase price must have been determined pursuant to a formula which was reviewed within three years prior to sale; (3) at the time of review, the formula must have been reasonably expected to produce a price which would approximate the fair market value as of the time of sale; (4) the property does not have a readily ascertainable fair market value; and (5) the property is not resold to an unrelated party within 6 months of the transfer or the decedent's death.

COMMENTS ON THE DISCUSSION DRAFT

We commend the Committee for the substance of the discussion draft. We also commend this process of offering draft statutory language as a focus for public comment. We at the Treasury have benefitted substantially from the opportunity to discuss the draft with interested members of the public, and we have received many constructive comments for improvement of the draft.

⁷ QFPs for trusts also include non-contingent remainders if all other interests in the trust are QFPs.

⁸ These trust rules are derived from the rules governing charitable remainder trusts, which were enacted to address similar problems of incorrect valuation of the various interests in such trusts. See IRC Section 664.

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We are prepared to support proposed modifications that improve the draft in terms of taxpayer flexibility, simplicity of administration and compliance, and that enhance the overall workability of the statutory framework. We will oppose, however, changes which would effectively undermine the premise of the discussion draft -- proper valuation. We believe that the discussion draft, by attempting to obtain the appropriate valuation of the various interests at the time of transfer, offers the best approach to this problem.

Without attempting to offer a complete list at this time, we believe the following modifications of the discussion draft would be appropriate:

- o Allowing transferors to elect to treat percentage leases and share-of-production royalty interests as QFPs;
- o Clarifying application of the rules to trusts by separating such rules from the basic rules applicable to corporations and partnerships; and
- o Clarifying the application of the rules in the case of generation-skipping transfers.

We are also considering other modifications and we hope to learn more from the testimony to be offered here today.

REVENUE CONSIDERATIONS

The Treasury's Office of Tax Analysis ("OTA") estimates that repeal of section 2036(c) would reduce revenues during the period 1991-95 by \$1.021 billion. (See the attached Table).

The revenue loss from repeal of section 2036(c) arises because the provision effectively prevents taxpayers from engaging in freeze transactions. Therefore, interests which otherwise would have been subject to freeze transactions will be retained and continue to appreciate in value in the hands of the older generation. As members of the older generation die holding such appreciated interests, their gross estates will be correspondingly larger, thereby increasing revenues. If section 2036(c) were simply repealed, freezes would resume (including abusive freezes which eliminate current value from the transfer tax base), and the appreciation that would otherwise be includible in the estates of the older generation will not be subject to tax.

OTA also estimates that, if the discussion draft in its current form were enacted to replace section 2036(c), revenues during the period 1991-95 would be reduced by \$50 million from current law. (See the attached Table).

CONCLUSION

The Treasury Department looks forward to working with the Congress and interested members of the public to develop a fair and workable replacement for section 2036(c). To retain our support, any proposal must prevent abusive valuations in estate freeze transactions. We are encouraged by the progress made to date.

Mr. GIBBONS [presiding]. Mr. Jenkins.

Mr. Downey.

Mr. Anthony. Mr. Anthony, do you have a question?

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Welcome, Mr. Gideon, before the committee. It is nice to see you.

In footnote 4 of your testimony, you suggest that Congress might consider including gift taxes paid in the transfer tax base. Would the administration view such changes as a tax increase? Isn't this, in fact, a suggestion that there should be a tax on a tax?

Mr. GIDEON. No, that is not our suggestion. We are testifying that we like the approach of the discussion draft. The footnote simply notes that there are alternative ways to address the basic issue.

Mr. SCHULZE. So you are not in favor of a tax on a tax?

Mr. GIDEON. We are not here to testify in favor of that today.

Mr. SCHULZE. Mr. Gideon, because of the rapid escalation in the cost of land in SMSA's and around metropolitan areas, family farms, many of which have been held in families for generations, are being sold to developers because of huge estate tax burdens.

Do you have any thoughts on this? Whether it is good social policy or whether it is good tax policy or whether this is the kind of effect we desire to achieve?

Mr. GIDEON. Well, we have special valuation procedures already with respect to family farms that are retained in the family and used for agricultural purposes. If those procedures are not working properly, I think if there were specific suggestions as to improvement, we would be happy to consider those.

I think it is important, however, to keep a couple of things separate. To the extent that we think we need to provide relief for small business or relief for family farms or anything of that sort, that really should be considered apart from the issue we have here today.

The issue here today is obtaining appropriate valuations. It seems to me that it is important to the integrity of any transfer tax system that we achieve appropriate valuations. That is what the 2036(c) issue is all about as opposed to what the proper policy should be with respect to exemptions from the estate tax.

Mr. SCHULZE. I understand that, but I also understand that you understand that sometimes it is difficult for us to get opinions from the Treasury on some of these issues even though they are directly related, so we are forced to take this opportunity and, quite frankly, that is why I am doing this.

Ken, in my district, in Chester County, Pennsylvania, a small family farm of, say, 50 acres valued at \$40,000 an acre, typically would sell for about \$2 million. Under current law that valuation would be reduced by \$750,000 under section 2032A. An estate tax would be levied on \$1.25 million. That tax would be \$687,000.

There is no way that a family heir, and especially a farmer, could possibly afford to pay that tax without selling the farm to a developer. This is not only commonplace, this is sort of a mild example.

Has Treasury ever tried to calculate how many businesses or farms are sold just to pay the inheritance tax?

Mr. GIDEON. We have not made such a calculation, Mr. Schulze, and I don't know that we could precisely do so.

I might note in respect to your hypothetical that for that level of tax to be imposed, one would assume that there is a substantial amount of other assets in the estate, because to assume the \$750,000 of property qualifying under section 2032A and the \$600,000 base exclusion that would be available, \$1.2 million in the case of a couple, the size farm that you are talking about, if it were the primary asset of the estate might be subject to very little estate tax.

Mr. SCHULZE. That really is a small example. Most of them are being sold in much larger multiples of a million dollars and it is causing quite a problem. It is actually forcing people to sell them to developers rather than retaining the local family farms, which are also good not only for the area but for the ecology and the ambience of the area.

Well, I am glad that you have a concern for this area and we will talk about it further as time goes on.

I thank you.

Mr. GIBBONS. Mr. Dorgan.

Mrs. Kennelly.

Mrs. KENNELLY. No questions, thank you.

Mr. GIBBONS. Mr. Coyne.

Mr. Andrews.

Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

I appreciate your testimony today. I have a couple of questions related to some of the provisions in the draft bill that you have referred to in your testimony.

I understand your position as it relates to certain rights that are discretionary in the older generation that may well not be exercised and distorts the valuation. But could you explain why the 20 percent rule on common stock, as to why, what you are trying to get at by that provision in the bill?

Mr. GIDEON. Well, think about the right to the future appreciation of the business as an option. In other words, an option to acquire all the potential appreciation in an enterprise is a valuable right. It seems to us that to allow this rule to work to the point that no value were attributed to that right to all future appreciation would be an obvious misvaluation. The choice of 20 percent is, of course, judgmental.

I might note that it is the level at which the ABA task force, which considered this problem earlier last fall, chose. It also happens to be a number that accords with our judgment as to about what the right level would be.

Obviously, though, setting percentages of that sort is going to be an issue that the committee will have to look at.

Mr. CARDIN. But if the underlying valuation is appropriate on the value of the business, the allocation between, in this case the preferred stock and the common stock, whether it be at 99 percent or 1 percent or 80 or 20, if the underlying valuation is proper, and the appropriate value has been placed on the asset that is being transferred, are you saying that there basically has to be some

price to be paid for getting an asset that is hopefully going to be appreciating?

Mr. GIDEON. Remember what we are trying to do here is get it approximately right. We think that it would be very unlikely that 1 percent in particular would be an appropriate value for all the right to future appreciation in an enterprise.

In fact, I think if you look at the practice of the more conservative practitioners even under old law, there were very few of them who would be willing to do a freeze as aggressive as the one you described and have any confidence that they had achieved a proper valuation.

Mr. CARDIN. I think I understand your point, but I am not sure I understand the rationale for using a percentage. If the underlying valuation is proper, the value of the preferred stock is going to be just as accurate, whether you use 80 or 99 percent.

Mr. GIDEON. Well, I would have to take issue with that. The point is that the underlying value cannot be proper if it ignores this option value of the common stock. I think with a limitation that preserves substantial value or significant value to the right to future appreciation, we think this rule works well. We think the rule becomes truly artificial if the transferred interest can be valued at almost zero because that is not what the market would do with respect to a right to all future appreciation in a business.

Mr. CARDIN. Let me try to get to a second point, if I might.

Many family businesses have a history of dividends that are paid and they want to continue that dividend policy. If I understand correctly, if they want to use, under the draft bill that is before us, dividends to the older generation, they are going to have to make those dividends cumulative dividends basically.

Mr. GIDEON. They have the option of not doing that for state law purposes. There is a provision in the draft bill that allows you to value noncumulative dividends, but you have to elect into this procedure. What that means is that if you don't pay you will have a gift, a deemed gift. But that is elective.

Mr. CARDIN. You can elect to use noncumulative dividends but if you don't pay it, it would not qualify as a fixed payment, right, that generates a subsequent gift?

Mr. GIDEON. The election in would turn it into a qualified fixed payment and the result of that would be if you didn't pay it then you would have a deemed gift.

Mr. CARDIN. You would not have to use the cumulative gift procedure?

Mr. GIDEON. You don't have to if you make the election.

Mr. CARDIN. Let me ask, your comments on the D.C. Bar's suggestion that there is really not that much of a problem prior to 1987, but for the enforcement and audit authorities of IRS. If we beefed that up in this area, there would not be a need to have the 1987 law.

Your comments on that as far as your enforcement rights?

Mr. GIDEON. With all due respect, I just don't agree with that with respect to the use of soak-up rights in valuations. I think that certainly we would be happy to consider some of the increased notice provisions, because I think they would be helpful in an audit context.

But if we fail to deal with soak-up rights, more audits cannot solve the problem. We think that is a fundamental problem of artificiality in the valuation process.

Mr. CARDIN. Thank you.

Mr. GIBBONS. Mr. Brown.

Mr. Thomas.

Mr. Brown.

Mr. McGrath.

Mr. Chairman.

I will try to get—are there members on either side?

Mrs. Johnson.

Mrs. JOHNSON. Thank you.

I am very interested in your testimony and I believe you make some very valid points. But when you look at the revenue estimates, current law generates \$1 billion, and the reform bill would cost only \$50 million.

The implication is that the draft will help very few people. That the draft doesn't, in fact, go to the problem that Mr. Schulze talked about and my concern is that it doesn't go to the problem of the small manufacturer who is the strength of our industrial base, at least in my part of the Nation.

There are big guys. But the little guys, many of whom are family-owned, are terribly important—whether or not the big guys will succeed out there in a very competitive environment.

In those small manufacturers, which is where I first came across this problem, the action we took in 1986 has been very hostile, not only to their ability to stay, but their ability to invest in the new equipment that will have future productivity and quality implications, but only over a number of years and would not directly benefit the current owners.

So when I look at your revenue estimates, I will have to ask you, if you were going to loosen this up a little bit to be somewhat more generous, which provision is key to that loosening process? Is it the 20 percent? Is it some other aspect of the bill? If you were going to look to make this somewhat more generous to the businesses affected, what is that lever that you would pull?

Mr. GIDEON. I really am not in a position today to comment on what changes would look like.

One of the things I have learned about the revenue estimating process is it is important to score a specific proposal. Therefore, I think it is dangerous to speculate on what revenue effects might result from specific changes.

Let me say I think it is important that we sort out two different issues here. One issue is the issue of whether we should give special relief to small business.

The other issue, which is I think the issue that is implicated by this provision, is whether we should have appropriate and proper valuations for gift and estate tax purposes. If the committee believes it should spend money in giving small business relief, it ought to do that explicitly.

It ought not to do it through a mechanism that would not be targeted to small businesses, that might benefit much larger entities as well—that permits, in effect, misvaluation.

I think it is important to get the valuation rules right and then to consider as a separate matter whether there needs to be specific relief in specific small business contexts.

Mrs. JOHNSON. I am reluctant to conclude that our ability to be that specific without policy overlays is really there. Family-owned businesses do represent a unique kind of small business with narrow-based risk and narrow-based benefits.

I think they deserve special consideration. Moreover, I don't know how you can be necessarily that precise without policy implications and without the prejudice your goals bring to us.

I hear your point about wanting to deal only with revenue estimates of specific measures. I think the revenue estimates that you bring to the table today indicate to me that we have got a long way to go.

I will be interested throughout the day to hear from those testifying to try to determine where it is that we need to look.

Mr. GIDEON. I would urge you to take a look at the revenue pattern in evaluating those estimates as well.

Mrs. JOHNSON. I appreciate that. That is also important. Thank you.

Mr. GIBBONS. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

I am sorry, Mr. Gideon, I was in another hearing. I missed your testimony. Let me ask you a couple of questions that may not have been covered. The effective estate tax rate today is what?

Mr. GIDEON. On average, I am sorry, I don't know.

I think that material might be covered in the joint committee—

Mr. LEVIN. It would appear on table 3, the value of gross estates subject to tax is \$70 billion; right?

The return is \$6 billion to the—if you look at table 3.

Mr. GIDEON. I might note this is estate tax, by the way, and not gift tax.

Mr. LEVIN. This is estate tax?

Mr. GIDEON. Yes.

Mr. LEVIN. That would seem to indicate there was an effective tax rate, I don't know if you can call it that, of what, 15 percent or a little more? I am not sure that is relevant.

We probably need to keep it in mind when we look at this issue. Don't you think it has some relevance?

Mr. GIDEON. I think it is important to realize there are substantial provisions for giving relief for family farms. There are substantial provisions providing significant exemptions at the bottom end of the estate tax sequence.

Again I would simply observe that if there is a feeling that more needs to be done with respect to small business exemptions, that ought to be the issue explicitly considered.

We should not engage in or allow misvaluation of transactions that do occur with the idea that somehow that is helpful in a small business context. This would be helpful to taxpayers in all contexts, but it basically undermines the appropriate working of an estate tax and transfer tax system generally. I just don't think that it is in the interest of the system to permit misvaluation.

Mr. LEVIN. Well, I hope that everybody hears that. I think what you are saying is that if there is too high a tax even with the present provisions, the 14-year provisions and others, if it still is too high a tax, we ought to change the rate for certain types of assets rather than doing it indirectly and essentially benefiting those who hired professional assistance and not those who did not.

Isn't that in terms of public policy a better way to go at it?

Mr. GIDEON. I couldn't agree more with that.

Mr. LEVIN. It seems to me that the committee ought to look at this openly. If small business and family farms, both of which we want to be darned sensitive to in terms of their place in the economy, if they are today being dually disadvantaged by the rates, change them.

Mr. GIDEON. I think that would be appropriate. As always, there are revenue concerns in any sort of change of that sort. But the appropriate way to deal with a problem like that is head on and directly where you know that the relief you are providing is going to go to the place you intend to provide it and not in a manner that would essentially be capricious as occurs by permitting misvaluations.

Mr. LEVIN. And to everybody, not those who simply are hiring the technical assistance necessary to lower their effective rate.

Thank you very much.

Chairman ROSTENKOWSKI. Further questions?

Thank you, Mr. Gideon.

Mr. GIDEON. Thank you.

Senator Symms, welcome to the committee. You know our procedures here. The committee is ready to receive your testimony.

STATEMENT OF HON. STEVEN D. SYMMS, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator SYMMS. Thank you, Mr. Chairman, and members of the committee.

I wish to thank you and the committee for the opportunity to appear here today. Mr. Chairman, I am the sponsor in the Senate of S. 659, a bill to repeal section 2036(c) of the Internal Revenue Code. I am here today to comment on the proposal to modify that section of the code, which you have published.

In my comments, I will discuss a number of reasons why I believe the proposal to reform section 2036(c) is not satisfactory. I appreciate that a lot of careful work went into the proposal, but I do not believe it has resolved the problems created for family businesses. I intend to continue my efforts to repeal section 2036(c) and correct the injustice imposed by that part of the Tax Code.

Before I address the specific concerns I have found in the proposal, let me say a few general things about the problem I see in section 2036(c).

First, I believe the estate tax as it is presently structured in our Internal Revenue Code is flawed in several ways. After a relatively generous exclusion for smaller estates—albeit an exclusion that is not indexed for inflation, and therefore one that becomes less and less in real terms year after year—the first bracket of the estate tax is a confiscatory 55 percent.

Is it any wonder, therefore, that family business owners and estate planners expend a lot of time and money working on clever devices and techniques to avoid paying such a high tax rate? The principle was clearly established by Congress in 1981 that the highest reasonable tax rate should be 50 percent on income from any source.

Senator Bradley and Congressman Brodhead led the effort in 1981 with the very logical argument that Congress had to make it more worthwhile for an American to earn an extra dollar than to hide an extra dollar from the tax collector. That is why the maximum tax rate should never ever exceed 50 percent, and indeed should be more like 28 percent or even lower.

I believe if we would extend this very simple principle of tax logic to the estate tax area, the problems we are trying to solve with section 2036(c) would cease to be problems at all.

I think the estate tax generates far too little revenue for the Federal Treasury, relative to what families expend on estate planning to avoid it. That is a sure sign that the tax rates are irrationally high.

The "estate freeze" that was seen as the problem section 2036(c) is designed to solve was simply one way around the confiscatory estate tax rates. It was, however, a meat axe approach—an approach that I believe is all too typical of the Treasury's philosophy. When they encounter an artful way to get around some provision of the code, they ask for more power to prevent it. We in the Congress are all too willing to grant the IRS an excess in discretionary enforcement power.

In the first place, a family business by definition will pass from one generation to the next. The younger generation will grow up in the business, learning how to make the business expand and succeed. At some point in the lives of both the younger family members and the senior family members, it will be appropriate to "pass the torch." Since the retirement income of the older generation may be critically dependent upon the continuation of the business, they will retain some ownership interest from which retirement income will flow. The needs of all businesses to have working capital will most of the time make it unfeasible for the retired family members simply to take their accumulated savings out of the business entirely.

Yet, from that moment in time, it is simply wrong for the estate tax liability of the older generation to remain linked to the business. Section 2036(c) basically says that the younger generation cannot get a clear title to the business. Section 2036(c) essentially says that all of the value added to the business during the lifetime of the senior family members must be taxed in the estate of the senior family members. And taxed, as I have said, at rates in excess of 50 percent.

Mr. Chairman, this is simply unfair. It is a violation of our basic concepts of justice and fairness. That is why I say we must repeal section 2036(c) and start all over again to think about the estate tax and problems in administering it.

Now, Mr. Chairman, let me turn to specific problems that I have with the proposal to reform section 2036(c). Let me begin by noting that the suggested new code sections are ridiculously complex.

Read sections 2701(d) and 2701(e), for example, and try to explain their meaning.

For about 100 years it has been part of our economic policy in this country to tilt in favor of the family farm. I think the general principle of that should apply to all family businesses, not just agriculture. I believe we should totally exclude from a person's gross and taxable estate the family business interests that are taken over by other family members. Families should be encouraged to keep their businesses and farms.

The vast majority of family businesses and farms will not be able to achieve a practical estate freeze if the proposed chapter 14 to the estate and gift tax laws is enacted. Owners will not be willing to commit to the cash flow mandated by the "qualified fixed payments."

The alternatives provided will not help the owners. Thus, there will continue to be significant estate taxes levied on family businesses and farms preventing orderly transfers to family members.

It is wrong to force corporations to either declare preferred dividends or face gifts or inclusions for the holders of preferred stock. The advisability of paying dividends is a business decision by boards of directors and it depends upon profits, working capital needs, plans for expansion, et cetera. The holder of the preferred stock frequently will have voting control and should not make or influence business decisions for his personal gain which might adversely affect other stockholders. He could be sued. This does happen between family members, but the drafters of this section seem to presume there would not be an arm's length business relationship. The concept is thus flawed and should be opposed.

Section 2702, as a practical matter, rules out all meaningful buy-sell agreements for family businesses. Buy-sell agreements containing formulas that may or may not equate fair market value at death are just as appropriate and necessary in family business situations as when the co-owners are not related.

In fact, they may be more important in family situations. Such agreements are made when neither party is sure who will be the first to die, and thus contain safeguards without the need for more statutory prohibitions and rules.

Section 2703 creates another set of family attribution rules. In fact, there are two new sets in this chapter 14. Add this to the sets in section 318 and 267, plus other provisions, and we may now have an approximate total of 10 different sets of family attribution rules.

Section 2703 provides that the "Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this chapter." The Treasury is now more than 10 years behind in issuing regulations. Why have more?

The new proposed statutory language must have been drafted by the same team that did section 2032A in 1986. You may recall that Congress had a wonderful idea to let family farms be taxed as farms. The staff converted this simple concept to 11 pages of statutory complexity. Many pages of regulations have only explained some of the questions. By my latest count, there have been 80 court decisions deciding 2032A issues. Sections 2701, 2702, and 2703 will provide a wonderful bonanza for tax lawyers to litigate.

Mr. Chairman, I want to thank you for this opportunity to appear before the Ways and Means Committee and tell you what I think is wrong. Frankly, however, I must say I will be trying to pass my bill, S. 659, and protect families who achieve every American's dream and really create a new business to pass on to the kids.

Chairman ROSTENKOWSKI. Thank you, Senator, for sharing these thoughts with us.

Any questions of Senator Symms?

Thank you.

Senator SYMMS. Thank you.

Chairman ROSTENKOWSKI. Mr. McGaffey, Mr. Wallace, Mr. Gamble, and Mr. Hoffman.

STATEMENT OF JOHN A. WALLACE, DIRECTOR, PROBATE AND TRUST DIVISION, AMERICAN BAR ASSOCIATION, SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW, AND PARTNER, KING & SPALDING, ATLANTA, GA

Mr. WALLACE. I am John Wallace, a practicing attorney in Atlanta, GA, representing the real property, probate and trust law section, and with my colleague Mr. McGaffey, representing the tax section, giving the views of the American Bar Association. Mr. James Gamble, with the American College of Trust and Estate Counsel is also on our panel.

We have formed a task force to consider section 2036(c) and what should be done with it. We are here as a panel as a result of that initiative. Mr. Hoffman's group, the American Institute of C.P.A.'s has consulted with us on our efforts.

First, we would like to praise the process that has preceded these hearings. Our conversations in private with staff, followed by their presentation of the discussion draft, circulation of that draft, further discussion on that draft after circulation and now these hearings, represents a refreshing change.

We stand for the proposition that section 2036(c) is unworkable, and should be repealed.

We agree as well that valuation problems exist in the so-called estate freeze area. In the estate tax system difficult to value assets are valued by assuming a negotiating process between a hypothetical willing buyer and a willing seller who are unrelated to each other. The typically constructed estate freeze in a family corporate recapitalization context, however, runs contra to that assumption because the parties are usually related to each other and the arm's-length dealing that is assumed in the hypothetical valuation standard typically does not exist.

Often taxpayers valued the preferred stock in recapitalizations by assuming that voting rights, conversion rights, put rights and other discretionary features bolstered the value of the preferred stock sufficiently to make it equal to the common stock that was exchanged in the recapitalization. Everyone knows it was unlikely, given the estate plan being implemented, that the holder of the preferred stock would exercise those rights in his or her economic self interest, hence, the problem. So, we agree that a problem exists.

We think it exists with respect to these discretionary rights attached to preferred equity interests, typically called bells and whistles that were never intended to be rung or blown.

We have developed a proposal, which we have discussed with Treasury and the staffs of the tax-writing committees in Congress, devaluing those discretionary rights. We submit that our proposal, which represents a departure from the hypothetical willing buyer/willing seller standard, is properly cast as a narrow departure from that standard because that standard has worked well in the rest of the estate and gift tax area over many, many years. As such, it represents a system that should be left in place with minor adjustments.

Chapter 14, the discussion draft that is before you, takes an opposite approach by declaring which rights and interests will have value and then stating that everything else will have no value. We take the view that the rules should designate the rights and interests which will have no value and declare that everything else has value. We are really looking at this problem from opposite ends of the telescope, if you will. We think our approach is better because it, frankly, puts the burden of uncertainty, that is the question of what is going to be deemed to have no value on the Treasury, and not the taxpayer.

Our proposal tells practitioners in this country what they cannot do; it allows existing rules, which are fairly well known, what they can do. It is a question of whether the glass is half empty or half full, that is, should you state what is wrong and declare everything else is right or should you state what is right and declare everything else is wrong?

Frankly, we think our approach, which may be more modest than the approach taken by the discussion draft, is the right one because if it doesn't solve all the problems that bring us here today, it is easier for you to enact legislation than it is for us to seek the repeal of the overbroad statute.

So, we would rather start in an orderly way at the beginning of the process and leave to future experience the question of whether to adjust the rules that are enacted in response to the estate freeze problem.

We have some specific concerns, Mr. Chairman, about chapter 14 beyond our elemental disagreement as to the approach that is taken to modify the hypothetical willing buyer/willing seller valuation standard.

Those specific concerns relate to the discussion draft's treatment of buy-sell agreements, which have been very useful tools for family planning in this area and which may be jeopardized under the requirements in chapter 14.

We also have concerns about chapter 14's treatment of options, leases, and other rather standard nonequity type arrangements that crop up all the time in family business settings.

In short, we applaud the process that has occurred. We agree that there is a valuation problem here that needs to be solved. We have a different approach for serving that problem that we have been discussing with the Treasury and your staffs prior to these hearings, and we represent to you that we will continue that discussion process.

Now I would like to turn our commentary over to Mr. McGaffey for more specific comments on the chapter 14 proposal that you have before you this morning, Mr. Chairman.

[The statement of Mr. Wallace follows:]

**AMERICAN BAR ASSOCIATION**

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STATEMENT OF JOHN A. WALLACE, ESQ.

Division Director of the Probate and Trust
Division of the Section of Real Property, Probate
and Trust Law of the American Bar Association

ON BEHALF OF THE AMERICAN BAR ASSOCIATION

At the Hearings before the
COMMITTEE ON WAYS AND MEANS
OF
U.S. HOUSE OF REPRESENTATIVES

Concerning Chairman Rostenkowski's discussion draft of a bill to
modify section 2036(c) of the Internal Revenue Code of 1986, as
amended, relating to estate valuation freezes

April 24, 1990

Mr. Chairman and Members of the Committee:

I am John A. Wallace, Division Director of the Probate and Trust Division of the Section of Real Property, Probate and Trust Law of the American Bar Association (the "ABA"). I have been designated to testify, along with Jere McGaffey, the Chair Elect of the Section of Taxation, on behalf of the ABA at these hearings.

First and foremost, we applaud the process that has preceded these hearings on Chairman Rostenkowski's discussion draft relating to estate tax valuation freezes. Having the opportunity to review in advance a draft of proposed legislation, meet with staff members to discuss the draft, and present testimony to this Committee before final decisions are made, are a vital part of a stable transfer tax system.

The ABA in August of 1988 adopted resolutions calling for the repeal of section 2036(c) and pleading for stability in the Federal transfer tax system. Those resolutions state the official policy of the ABA today.

In the press release announcing this hearing Chairman Rostenkowski referred to the "legitimate complaints" about section 2036(c), while indicating that a replacement is needed to "preserve the integrity of the Federal estate and gift tax system." We believe that the repeal of section 2036(c) is necessary to preserve that systemic integrity. Further, with all due respect and admiration for those who have worked diligently to develop Chairman Rostenkowski's discussion draft, we believe that it shares with section 2036(c) enough of the same flaws (including extraordinary complexity, ambiguity, overbreadth and inadministrability) to continue the present threat to the integrity of our transfer tax laws. That it may represent some improvement over section 2036(c) is not enough to warrant enactment in its present form.

REPEAL OF SECTION 2036(c)

Planning for the disposition of interests in closely held businesses and farms is often essential to the survival of such enterprises. Given the importance to this country of private enterprise and the orderly transmission of private property, the Federal system of taxing the transfer of such property must be understandable, stable, reasonably administrable and perceived as essentially equitable.

Section 2036(c), by virtue of its breadth, complexity and inability to be consistently administered, has made planning for the disposition of such property virtually impossible. In addition, because it treats family members doing business together more harshly than unrelated business partners, it is perceived as inequitable. As a result it has posed a serious threat to the preservation of family businesses and family farms and generated great instability in the Federal transfer tax system.

The American system of voluntary compliance depends upon taxpayer confidence in the fairness and stability of our tax laws. For this reason, and for those set forth below, section 2036(c) should be repealed and replaced only with a statute that is understandable, narrowly focused, and capable of being efficiently and evenly administered.

Introduction and Background:

Section 2036(c) was added to the Internal Revenue Code by the Revenue Act of 1987 and substantially modified in the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). It is a transfer tax (i.e., estate, gift and generation-skipping transfer tax) provision that appears to have been aimed initially at halting a business owner's perceived ability to transfer a disproportionate right to future appreciation in the value of a

business without being subject to an appropriate transfer tax liability.

Under prior law, some business owners made gifts of common stock, while retaining preferred stock in the same corporation, and claimed that the preferred stock represented substantially all the value of the business at the time of the transfer so that little or no gift tax was paid on the transfers of the common stock. Further assuming that the common stock would soak up any future appreciation in the corporation, these owners anticipated a "freeze" in the transfer tax value of their retained business interest at its value on the date of the transfer of the common stock. The principal concern leading to the enactment of section 2036(c) was a fear that these disproportionate appreciation transfers were being seriously misvalued for transfer tax purposes.

That concern could probably have been met by improved enforcement of existing rules. After all, the IRS has developed a substantial expertise in valuing closely-held business interests over the years, and increased transfer tax exemptions have led to the filing of fewer estate and gift tax returns which are likely to receive greater audit scrutiny. Significant undervaluation penalties exist to assist the IRS in this effort. Instead, section 2036(c) was enacted. As originally written, and even after amendments in 1988, the statute remains dangerously overbroad and ambiguous, and aimed almost exclusively at family-owned businesses. IRS Notice 89-99 provided useful interpretation of some of the issues in section 2036(c). It could not, however, cure all of the flaws in the statute. Further, many essential questions were left open for later regulations. There is virtually universal agreement that this statutory provision is unworkable. In our view, this state of affairs is a direct result of efforts to make section 2036(c) apply to multiple and diverse transactions that do not necessarily relate to the original statutory purpose.

For example, section 2036(c) hurts family businesses by creating a potentially enormous penalty for gifts or sales within a family (in the form of a later transfer tax), thus making it more desirable to sell a business to an outsider than to keep it in the family. Section 2036(c) is also being applied to many nonbusiness transactions, including transfers to garden-variety trusts. This amounts to a radical revision of the transfer tax system, and represents a far reaching change that was accomplished by indirection and without legislative hearings. The legislative history gives no indication that Congress recognized the fundamental changes being made by this new provision with its "Alice in Wonderland" approach to transfer taxation, in which transfers "in effect" occur and individuals are taxed on property long after they have irrevocably severed all connection to it. Section 2036(c) represents the first time that the transfer tax has diverged to this extent from basic property law concepts, the first time that sales for full fair market value give rise to transfer taxation, and the first time that an action taken by one spouse is deemed taken by the other spouse for transfer tax purposes.

Fortunately it now appears that these startling departures from traditional transfer tax principles are being recognized and corrective action is being taken. Section 2036(c) originated as a response to a valuation concern but now threatens to undermine the entire transfer tax system. It operates improperly and, as a solution to a specific abuse, its effects are not commensurate with the targeted problem. Its flaws are fundamental, varied and irreconcilable, and it should be repealed.

JOINT TASK FORCE RECOMMENDATION

The Real Property, Probate and Trust Law Section is part of a joint task force formed with the Section of Taxation of the

ABA and with the American College of Trust and Estate Counsel (formerly the American College of Probate Counsel) to develop an alternative to section 2036(c). The joint task force has formulated an alternative based on the belief that the abusive estate freeze problem that gave rise to section 2036(c) is essentially a valuation issue. In many preferred stock recapitalizations the preferred stock exchanged for common stock is valued equally to that common stock even though the preferred stock does not bear a cumulative dividend at a market rate. This valuation position normally is justified by incorporating various features in the preferred stock in the form of rights given to the holder that are not expected to be exercised. The potential for abuse is therefore confined to private corporate and partnership interests owned by one family or by several families with proportionate interests, where decisions to exercise discretionary rights are typically not made on an arms-length basis.

Under the joint task force recommendation nonpublicly traded stock and partnership interests are to be valued for gift tax purposes by assuming that any discretionary liquidation, conversion, dividend or put rights in the stock or partnership interest retained by the donor or the donor's spouse will not be exercised by them in a manner adverse to the donee's interest if the donee is a member of the donor's family. This rule effectively increases the value of the transferred interest. Because this assumption against economic self interest runs contrary to normal experience, the task force rule represents a departure from the usual hypothetical willing buyer/willing seller valuation standard. We recognize that any shift from this standard is problematic and should be limited to very specific transactions. In short, we believe that a modest deviation from the basic valuation standard is justified to meet Congress' concerns with respect to abusive estate freezes, but the application of the new rule should not extend beyond that particular target.

We have submitted our proposal to the Treasury Department and the staff of the Joint Committee on Taxation. We appreciate the consideration it received and the role it played in the development of the proposed Chapter 14 contained in Chairman Rostenkowski's discussion draft.

THE DISCUSSION DRAFT

We commend the Treasury and Congressional staffs for the basic approach of the discussion draft, which adopts a valuation based solution to the estate freeze valuation problem. We have conscientiously studied the Chapter 14 approach and conclude that it is both an excellent effort and an unsuccessful one--at least in its present form. We believe it is an excellent effort because it creatively and directly seeks a valuation solution for a valuation abuse and attempts to apply that solution fairly by including numerous and complex adjustments for tax overpayments caused by the statute. We believe it is unsuccessful because it suffers from the major shortcomings of section 2036(c), namely, it is overbroad in its application to perfectly legitimate transactions and represents an extraordinarily complex response containing significant ambiguities. We believe it too will prove unworkable (impossible to understand and evenly administer) and will operate mainly as an in terrorem device that inhibits desirable, nonabusive family and business transactions and will be ignored by many potential tax abusers. Further, we believe that Chapter 14's failings are directly attributable to its attempt to be an objective, airtight solution to a subjective, fact specific problem.

Explanation:

The discussion draft has four major parts:
(1) retroactive repeal of section 2036(c); (2) special valuation

rules applicable to "10% owned" corporations, partnerships and trusts, (3) a rule setting forth specific requirements that would have to be met in order for options held by family members to be taken into account in valuing property, and (4) a revision to the gift tax statute of limitations. Special rules are also included treating transfers made by one spouse as if made by the other in limited situations and treating all persons who are donees (without regard to Chapter 14) as if they were family members of the donor.

The discussion draft contains a number of technical errors, many of which possibly may be identified and cured prior to enactment. Our testimony, therefore, does not focus on these technical errors except to mention them as an example of the provision's extraordinary complexity. We intend to submit a separate list of our technical comments for the benefit of the Committee and its staff. The purpose of the balance of this testimony is to raise substantive concerns about the operation of the proposed replacement rules.

The discussion draft provides that, with respect to gifts of an interest in a "10% owned" partnership and corporation, any interest retained by the transferor (or a family member other than the transferee) has no value unless that interest is (i) a "qualified fixed payment" (QFP), (ii) an interest in the same class as what is being given away, (iii) a voting right, or (iv) an interest with no preference over the transferred interest. An interest in a corporation or partnership is a QFP if it is (i) a right to dividends payable at a fixed rate on a periodic basis on a cumulative preferred stock, or (ii) the right to any other payment or distribution if fixed as to both amount and time (and not subject to a life contingency). In addition, a floor is set on the value of all junior equity interests, such as common stock, by providing that such interests be valued at not less than 20% of the sum of the equity in the corporation or partnership and all debt owed to the transferor and members of his or her family.

Rights to QFPs are valued with two special assumptions: (i) that all payments will be made when due and (ii) if there is no termination date, that payments will be made forever. However, if a QFP payment is not made by the end of the third calendar year following the year in which it was due, then a deemed gift will occur unless the corporation or partnership is bankrupt or insolvent. Adjustments must be made in the values of retained interests to reflect such deemed gifts. A taxpayer can elect (i) to treat rights to dividends under a noncumulative preferred stock interest as a QFP and (ii) to treat rights to partnership payments as a QFP where the right was not treated as a QFP solely because any such payment was contingent on and limited by the income or cash flow of the partnership. Thus, a sole shareholder of a \$2,000,000 corporation who holds common stock worth \$1,000,000 and non QFP preferred stock worth \$1,000,000 (perhaps because it must be redeemed 2 years in the future for \$1,200,000) will be subject to tax on \$2,000,000 upon the transfer of the \$1,000,000 of common stock. Furthermore, as presently drafted, there would not be an adjustment to compensate for the gift tax overpayment when the retained preferred stock is redeemed for \$1,200,000, thereby augmenting the estate of the original shareholder.

With respect to trusts, the discussion draft provides that a retained interest by a grantor would not reduce the gift tax value of a transfer in trust unless the retention constitutes a QFP of a different but comparable sort. A retained interest qualifies as a QFP if it is the right to (i) an annuity, (ii) a unitrust amount, (iii) payments under a debt instrument or a lease that are fixed as to both amount and time or (iv) an amount payable under a noncontingent remainder interest if the preceding rights under the trust are described above. Thus, under this proposal, where an individual transfers property in trust retaining the right to trust income, a gift tax must be paid on the full amount placed in trust because a retained income interest, which is not a QFP, will be valued at zero.

With respect to options and agreements, the discussion draft essentially provides that options held by family members would not be taken into account in valuing property unless (i) the option is actually exercised, (ii) the property does not have a readily ascertainable fair market value, (iii) the property is not resold to a nonfamily member by the person exercising the option within six months of the decedent's death and (iv) the option price is determined under a formula which had been reviewed within three years of the event triggering the option and which at the time of the review was reasonably expected to produce a price approximating fair market value at the time of sale. The statute also provides that the value of property subject to rights of first refusal, leasehold interests or other transfer restrictions held by family members will be determined without regard to such rights. Thus, if a parent and child each owned 20% of a corporation and are subject to a shareholder's agreement entered into for a business purpose providing that upon a shareholder's death the company must buy and the shareholder's estate must sell all of the shareholder's stock at a price determined pursuant to a formula that was not reviewed within three years, then the parent's estate may be subject to tax at a value significantly higher than the amount actually received under this legally enforceable agreement, even if the reason for the failure to review was outside the control of the parent and the child.

In the case of transfers subject to Chapter 14, the discussion draft extends the basic gift tax statute of limitations from three to six years and provides an unlimited statute of limitations for undisclosed transfers.

Basic Distinction Between Proposals Causing Concern:

The most fundamental distinction between the task force recommendation and the discussion draft, and the one that gives us the biggest concern, derives from the discussion draft's sweeping departure from the willing buyer/willing seller valuation rule in a manner that is light years beyond the limited departure from the rule contained in the joint task force recommendation. The discussion draft provides that only certain very narrowly defined retained rights or interests have value, and assigns no value at all to everything else except voting rights. It makes its new valuation standard, rather than the time honored willing buyer/willing seller standard, the norm by assigning a zero value to all assets and interests within its scope unless they fall inside its narrow view of assets deemed to have value. The joint task force recommendation takes the opposite tack of preserving the current willing buyer/willing seller standard with a narrowly crafted exception for certain valuation techniques that have, in practice, been used to justify abusive valuation planning. The ultimate consequence is that Chapter 14 frequently will require taxpayers to pay gift tax on grossly inflated values, or to refrain from making gifts of closely held property interests or participate in intrafamily sales of such interests.

Flaws in the Discussion Draft:

As previously stated, the discussion draft ignores, i.e., values at zero, valuable retained interests having little transfer tax avoidance potential. We have been asked repeatedly to provide the staffs with a list of interests or rights that would be unfairly ignored by Chapter 14. We are in the process of compiling such a list. It includes, among other items, mandatory conversion rights, the right to use property held by the entity, as opposed to the right to income from it, automatic calls, or such rights exercisable by nonfamily members, consumer price index adjustments, and all rights tied to production or unit values, such as royalties, lease override payments, and participating preferred stock. We are confident that many additional examples of similar rights created in the ordinary course of business exist. Experience shows that innovative financiers are constantly

creating new types of equity interests for public corporations that are being emulated by family businesses.

As stated earlier, Chapter 14 suffers from many of the flaws of section 2036(c). It contains fundamental uncertainties and ambiguities. After weeks of study, neither we nor the staff members to whom we have spoken can state with certainty whether and to what extent it applies in a variety of common situations. For example, it is not clear whether and to what extent the discussion draft would apply to a lifetime transfer of preferred stock to a child not active in the family business and common stock to a child who is active in the family business. The answer may depend upon a number of incidental factors such as the order of the two gifts, whether the gifts are considered part of the same transaction and whether the transferor/parent directly retains any interest in the stock. To the extent the provision would apply, it is not clear whether, if the preferred stock gift was made first, there would be any adjustment to prevent a double tax from being paid on the value of the preferred stock.

By treating pure debt and leases as equity interests in the entity, the discussion draft creates the potential for inadvertent triggering of the provision. As discussed below, it unnecessarily attacks buy-sell agreements. Its rule for trusts add an avoidable complexity to provisions aimed principally at partnerships and corporations, and, like section 2036(c), makes indirect and fundamental changes in the taxation of trusts that are inconsistent with our basic system of taxing such entities and are not required to reach the targeted abuses. Chapter 14 even applies in certain situations where section 2036(c) itself did not apply. For example, if a parent transfers 10% of his common stock and 10% of his preferred stock to a child, section 2036(c) would not apply, but proposed section 2701 would overvalue the initial transfer for gift tax purposes, requiring the payment of an excess gift tax followed by a later adjustment.

The discussion draft is overbroad in several different ways. First, where it applies it ignores too many rights that can be reasonably valued. In doing so, it blurs property law distinctions and, in some situations, even independent individual taxpayers and family members are treated as a unit. Second, its 10% ownership test applies to too many taxpayers; if the goal is to prevent manipulation and if attribution rules are to be applied as presently written, a test consistent with the ability to manipulate, usually more than 50% ownership, would be appropriate. Furthermore, the use of the attribution rules should be presumptive only, rebuttable by the taxpayer's showing of family hostility.

The Chapter 14 approach of granting only qualified fixed payments or voting rights value, represents, as noted earlier, a substantial departure from the willing buyer/willing seller determination of fair market value. As a result, it divorces the tax base from even theoretical reality and raises to a very high degree the likelihood that there will be instances of a confiscatory tax (i.e., where the tax equals or exceeds the "true" fair market value of the property transferred). Taxpayers' ability to pay the tax is clearly jeopardized by this approach.

The willing buyer/willing seller valuation rule is embodied in section 20.2031-1(b) of the estate tax regulations, which states that "the fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." This standard has stood the test of time and generally works to value property for tax purposes at a realistic price. Revenue Ruling 59-60, 1959-1 C.B. 237, has amplified the rules for determining the fair market value of stock of closely held corporations under this standard, with only slight modifications, for more than 30 years. The approach taken in Chapter 14 would totally ignore and distort these long standing authorities for an untried and complex

substitute set of rules that would necessarily ignore the facts; the change is startling and disconcerting, to say the least.

Another troubling similarity to section 2036(c) is the extreme hardship that Chapter 14 could cause closely-held business owners not engaged in tax motivated transactions. The deemed gift provision is a good example of the potential hardship. Consider a corporation in which a parent owns \$3,000,000 of 10% cumulative preferred stock and his child owns the common stock. If the corporation has some bad times and is unable to pay the preferred stock dividends for several years, the parent may be subject to gift tax on a \$300,000 deemed gift at a time when he may already be feeling a financial squeeze because he is not receiving the dividends on which he depended. There is a safeguard in the discussion draft for insolvent corporations, but this is grossly inadequate to deal with the many potential hardships falling short of insolvency that might be encountered. Furthermore, in determining insolvency, debt owed to the preferred shareholder and his or her family members would be ignored, increasing the likelihood that hardships will occur in struggling family businesses.

The 20% minimum value requirement in Chapter 14 will create similar hardships. This rule, while perhaps appropriate in some cases, is inappropriate with respect to a troubled company--perhaps a company going through transition in management from parent to child where common stock ownership is the inducement the child needs to persevere with the company. The joint task force recommendation contained a similar rule--but only in the context of meeting a safe harbor, not in the context of an exclusive valuation rule.

Buy-Sell Agreements:

We are opposed to the discussion draft's provision ignoring buy-sell agreements, options and restrictions held by family members because it too creates conclusive presumptions in a fact specific area and inhibits the use of legitimate business or estate planning techniques. Pre-section 2036(c) law, embodied in section 20.2031-2(h) of the estate tax regulations, contains appropriate safeguards against abusive buy-sell agreements. It provides that options or contract prices are disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case "that the arrangement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." This standard has been successfully applied by the courts to prevent abuses of the normal valuation rules. Furthermore, if there is a concern that this test is uncertain or not being interpreted properly, then the test could be clarified.

There are many legitimate nontax reasons for having buy-sell agreements.* These reasons lead parties to set prices geared to what they believe to be the fair market value for the company, usually by employing a valuation formula that adjusts appropriately for changing economic conditions. Often the parties also take into account their desire that the company survive the death of a partner or shareholder and establish a price that would not cripple it. In all cases, buy-sell agreements create a system of rights and obligations that are to apply at a future point in time and allow the parties to plan in a stable environment for future contingencies. Often situations change after the agreement is entered into making it practically impossible to reopen the agreement.

* For example, buy-sell agreements can be used to create a mechanism for an amicable separation if shareholders cease to get along or to provide a market for an essentially unmarketable minority interest in order to obtain the liquidity to pay taxes.

Buy-sell agreements and stock transfer restrictions can help many families keep the businesses together by solving potential problems regarding the disposition of the stock or the partnership interest at the death of a shareholder or when the shareholder leaves the company. It can provide a mechanism for determining the otherwise unknown price of a particular ownership interest in a company or a partnership. It can prevent the sale or other disposition of business interests to someone outside the family or to someone who is not acceptable to the other owners. It can provide a mechanism for liquidating on an equitable basis the ownership interest of a decedent or someone leaving the partnership or the company. Another important purpose of the buy-sell agreement is to provide adequate liquidity upon death so that the estate taxes can be paid. Their validity and use, already policed by an adequate set of safeguards, should not be inhibited by the heavy handed approach proposed in the discussion draft.

Finally, the discussion draft rule forces a valuation differential between the fair market value of business interests subject to buy-sell agreements and other stock restrictions for estate tax purposes and for state law purposes, thereby imposing serious and undesirable hardships on taxpayers who use these heretofore standard arrangements to facilitate their business and tax planning. A rule of this sort can have extraordinarily harsh and unintended results. Consider the case of a decedent who leaves to his spouse stock in his closely held corporation that is subject to a mandatory buyout under a buy-sell agreement. If the buy-sell agreement is not recognized for estate tax purposes under proposed section 2702 the gross estate would include a value higher than the value in the buy-sell agreement whereas the marital deduction would be limited to the value in the buy-sell agreement. The differential in value would be subject to estate tax and that estate tax could in turn further reduce the marital deduction in a continuing spiral until it subsumes the entire marital gift. Under pre-section 2036(c) law, this result could occur only where the buyout obligation itself is a disguised testamentary transfer to the other shareholders. The whipsaw effect produced by this one element of the discussion draft illustrates why an objective, all encompassing rule is an inappropriate approach for Congress to take in the estate tax valuation area.

Grantor Retained Income Trusts and Joint Purchases:

We question the discussion draft's treatment of grantor retained interest trusts (GRITs) and joint purchases because it increases instability and uncertainty in the estate and gift tax area. The discussion draft effectively eliminates GRITs currently permitted under section 2036(c)(6) and joint purchases by valuing the retained interest at zero and taxing the entire value of the property involved in the transaction as a transfer from the holder of the current interest to the holder of the remainder interest. With respect to GRITs, this treatment represents a complete reversal of the decision reached when Congress last visited this issue in TAMRA less than two years ago, and leads one to ask what has happened in the interim to cause an about face of this sort within such a brief time frame.

Put more broadly, this questioning of certain split interest transactions apparently reflects a concern that the Treasury Tables do not work well in the context of these two specific cases because the taxpayer may secure an advantage if the current yield of the subject property falls below the assumed rate of return in the tables. On the other hand, use of the tables to determine the transfer tax consequences of gifts of life estates and terms of years, or the transfer tax implications of charitable lead and charitable remainder trusts, will work to the advantage of the Treasury under similar circumstances. We question whether a change that rejects the use of the tables where they work against the Treasury, but insists upon their application where the

opposite result occurs, represents good tax policy and fosters likely taxpayer agreement that our transfer tax system is fair, equitable and worthy of their highest standard of voluntary compliance.

This suggests to us that any review of the taxation of split interest transactions for transfer tax purposes should examine more than particularized aspects of the topic without regard to whether the outcome from a given rule produces a benefit for the Treasury or for taxpayers. Hopefully, this overall analysis will shed light on the vexing issue of the appropriate use of administratively convenient and understandable tables in a transfer tax system that offers taxpayers and their advisors complete freedom to transfer assets of their sole choosing.

REVENUE ESTIMATES

In 1989, in connection with the Senate's vote to repeal section 2036(c), the cost of repeal without a replacement was estimated at \$245 million over three years and \$978 million over five years. We find such a large revenue loss both surprising and out of sync with the estimates that were published when section 2036(c) was enacted in 1987 and modified in 1988. In 1987 it was estimated that section 2036(c) would raise \$109 million over three years and the 1988 modifications were estimated to lose \$1 million over four years.

In order for any revenue to be lost within the next five years by the repeal of section 2036(c), one of the following three scenarios would have to occur:

- (1) an actual transfer after December 17, 1987, and prior to repeal, triggering section 2036(c), followed by appreciation in the property transferred and the death of the transferor within five years of the repeal;
- (2) an actual transfer after June 21, 1988, and prior to repeal, triggering section 2036(c), followed by appreciation in the property transferred and an event triggering gift tax consequences occurring within five years of the repeal; or
- (3) a transfer after repeal that would have triggered section 2036(c) had it not been repealed, followed, within five years of the repeal, by appreciation in the property transferred and by either the death of the transferor or an event that would have triggered gift tax.

On the other hand, it should be noted that all appreciation that occurred prior to repeal on property not transferred by reason of section 2036(c) would remain subject to transfer tax.

Recognizing that there can be widely divergent views on any behavioral assumption, it is hard for us as attorneys practicing in this area, to imagine that the total of such scenarios would result in tax consequences anywhere near \$1 billion (even at a 55% tax rate). Even if the revenue estimates are accurate, we believe that the joint task force recommendation would more than make up for any revenue loss over the next five years because (i) it would generate revenue by inhibiting most, if not all, of the same tax avoidance transfers and (ii) it would generate increased gift tax revenues even where the transferor does not die within five years.

SUMMARY

Chairman Rostenkowski in his announcement which accompanied the discussion draft stated that the draft which would replace section 2036(c) was "intended to accomplish similar objectives in a less burdensome and more focused manner." Further, he said that it was his hope that the modifications would address legitimate complaints about the current law provisions "while seeking to preserve the integrity of the Federal estate and gift tax system."

We continue to applaud these goals and the process being followed to achieve them. We do not believe the discussion draft meets these goals, however. Moreover, we believe the joint task force recommendation meets these goals. Further, as it applies to those taxpayers who attempt abusive estate freezes, it will have much the same tax effect as the discussion draft. We respectfully suggest it be given further consideration. Even if the joint task force recommendation is not followed, we continue to be willing to assist in the efforts to produce a more narrowly focused workable provision and to secure a repeal of section 2036(c).

Towards this end, we intend to submit additional comments on the discussion draft, which will include both substantive and technical concerns. In addition we join in the comments submitted by the others on this panel and share the concerns raised in their testimony.

We appreciate the opportunity to be heard today.

STATEMENT OF JERE D. McGAFFEY, CHAIR-ELECT, AMERICAN
BAR ASSOCIATION, SECTION OF TAXATION

Mr. McGAFFEY. I am Jere McGaffey, chair-elect of the section of taxation and testifying with my colleague John Wallace on behalf of the American Bar Association.

I want to second John's compliments to the procedure here used. Staffs have been very willing to talk to us about this section. Having detailed language forced us all to focus on some of the difficult problems.

I think in our testimony we have come up with a lot of detailed comments which I hope will be helpful. Whatever the end result, I think the statute will be better for having detailed language available early for comment.

We agree with the testimony of Treasury this morning that there were abuses that need to be solved by the statute. We concur with the discussion draft that the problem is one of valuation and is best solved by a gift tax solution.

Our approach was one of defining what was bad of the so-called soak-up rights, in the terminology of Treasury, and not giving them value. The discussion draft attempts to define what is good. We believe that approach is a much more difficult one because it must be much more all encompassing.

We have included in our testimony an appendix of matters which we believe should be included as being good that have not been included in the discussion draft. One appendix deals with those which we believe were unintentionally omitted in the draft.

The second list involves those transactions which we believe probably were focused on but were not included as being good and should be.

For example, the discussion draft covers leases.

If a child owns a business in a corporation that is a retail business, which is leasing the real estate used in the business from a third party, it would be quite common for the rental to be based as a percentage of sales. If the parent then buys that real estate from the third party and continues exactly the same lease, under the discussion draft that will be deemed a gift from the parent to the child. In our experience, leases have not been used in abusive freezes. We see no reason for them being included in the discussion draft.

Similarly, we believe debt should not be included. Prior to 2036(c), there was an adequate section which dealt with debt. Any debt on which interest was not paid or the interest was inadequate gave rise to a gift in the amount of the below market rate interest.

If a child had a business and needs some funds and the parent loans money on a demand no-interest basis, under the old law it would be deemed a gift of the amount of interest that is not paid. Under the discussion draft, it will be deemed a gift of the entire principal. When the principal is repaid, there is no provision for refund in the discussion draft.

We believe the discussion draft provides for a gift on the failure to pay dividends which are not motivated by tax considerations. Assuming a business which is owned by a parent and two children, one of which is active in the business and one not. The one that is

active in the business is contributing to its growth, wants to have that growth, and the parent is ready to retire. The other child is not in the business and is very angry that such child is not receiving any income from the business, so the business is recapitalized with the parent and the inactive child taking preferred.

Expecting the dividends to be paid, the parent retires and the other child lives off of the dividends. The child active in the business doesn't run it very well and quits paying dividends. The siblings do not have kindly relations at this time by reason of the failure to pay dividends.

This proposal would impose a gift tax from one sibling to another in that situation, adding insult to the injury of not receiving the dividends. We believe that there are a number of areas like this that should be addressed.

Although we prefer the task force approach, whereby, what is bad is defined if the revisions that we suggest in our testimony were adopted, we could support the discussion draft.

We are very willing and anxious to work with the staffs of the tax-writing committees and Treasury in attempting to develop a suitable solution to this problem. We believe that the steps that have been taken so far are good first steps in that regard, but that much work needs still to be done.

Thank you.

[The statement of Mr. McGaffey follows:]

TESTIMONY OF JERE D. MCGAFFEY
ON BEHALF OF THE SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

on

"Discussion Draft" relating to
Estate Valuation Freezes

House Ways and Means Committee
April 24, 1990

Good morning. My name is Jere McGaffey. I am Chair-Elect of the Section of Taxation of the American Bar Association. I am one of two spokespersons on behalf of the American Bar Association.

I am pleased to be able to testify today on a proposed alternative to the present Section 2036(c). We want to compliment all of those involved in the procedure concerning this alternative. The staffs of the tax writing committees and the Treasury have been interested in our views as to an alternative. We believe that having the statutory language of the Discussion Draft has forced us all to focus on many difficult problems and has been a very helpful step. We appreciate the opportunity of hearings to comment on the Discussion Draft. We believe such procedures will make for better tax legislation, whether we completely agree or not with the ultimate results.

We are very pleased that repeal of Section 2036(c) is being considered. Repeal of Section 2036(c) has been the position of the American Bar Association. We recognize the need for a substitute. We believe prompt action in this area is necessary.

Prior to the enactment of Section 2036(c) there were valuation abuses in certain freeze transactions. The most typical of these were situations in which a corporation was recapitalized, the parent taking preferred stock, which purported to have virtually all the value of the corporation, and then giving the common to children. The corporation normally was unable to pay a dividend at market rates on the amount of preferred that was issued (seldom would an active business have cash flow equal to a market interest rate on its entire value). If the preferred was made cumulative and the dividend not paid, the growth of the preferred's liquidation preference could grow to be more than the entire value of the company. Therefore, noncumulative preferred was issued. Noncumulative preferred would normally not have significant value unless there was some compulsion to pay dividends. To increase its value various features ("bells and whistles") were added to the preferred. These might be features entitling the preferred to cause the corporation to repurchase the preferred at any time at its par value (put rights), a right to require liquidation at any time or a right to convert the preferred at any time into common having a value equal to the preferred's liquidation preference. All of these rights gave an arguable value equivalent to the liquidation preference. However, the parent would not exercise these rights and thus the growth in value of the business would all increase the value of the common stock held by the child. In this manner the parent's estate was frozen and the appreciation was transferred with little or no gift tax.

Something needed to be done to prevent such transactions. Section 2036(c) prevents such transactions by including in the parent's estate the value of the common since the transactions were a transfer of a disproportionate amount of appreciation while retaining an interest in the enterprise.

Whereas Section 2036(c) prevents abusive recapitalization it goes much further. It prevents all divisions of ownership between family members. Some of these were neither abusive nor motivated by estate tax avoidance considerations. A parent may have reached the point in life where retirement was desired and a child may have been active in the business desirous of taking over the management. In such situation it was appropriate for the parent to receive preferred stock with an adequate income stream to provide support and the child to receive the growth which the child was creating. A child may have a business which required additional capital which the parent advanced through a preferred stock issue in order to provide capital and to increase the business's borrowing base. There was even concern that Section 2036(c) might apply in situations in which an unrelated employee received common stock at less than fair market value as part of a compensation package, if there was preferred stock held by the major owners.

Many practitioners did not realize the breadth of Section 2036(c) until it was amended, to create purported safe harbors, and it was recognized that it applied to loans, leases, employment agreements and buy-sell agreements. What one had thought was primarily a regulator of capital structure became also a regulator of compensation agreements. If the corporation had only common stock and annual gifts were being made by parent to child, if the parent had a more than three-year employment agreement, if salary was based on income or parent participated in a bonus program based on profits these gifts would be included in the estate.

There is great uncertainty as to the possible breadth of Section 2036(c) and a closely held corporation cannot take any action with their shareholders without considering the possible application of Section 2036(c). It has greatly increased the importance of estate planners with their corporate partners but both partners and clients are amazed at the implication of Section 2036(c).

Details of problems with Section 2036(c) have been dealt with elsewhere and I assume all parties realize some different approach to the problem is necessary.

After the American Bar Association went on record as favoring repeal of Section 2036(c) the Section of Taxation formed a task force to consider alternatives to deal with the abuses in the area. This task force then worked with a joint task force of the Section of Real Property Probate and Trust and American College of Trust and Estate Counsel. We believed that the basic problem was the valuation of the gift at the time of a recapitalization. The problem arose by the use of special discretionary rights (puts, conversion features, etc.) which would give value to preferred stock even though the dividends were noncumulative. The problem arose because such rights would have substantial value if held by a third party. A related party could fail to execute such rights and thus give value to the instrument which really was not retained. Our solution was to recommend that such discretionary rights should be disregarded in the valuation process. (The task force recommendation is attached as Exhibit A). We provided a safe harbor which contained

elements of compounding the cumulative feature and a 20% minimum capitalization as well as a safe harbor interest rate. These were not intended as requirements but a safe harbor and to imply factors that should be considered in valuation. We also were mindful of the fiscal effects and recognized that a gift tax approach would in the short run always raise more money than an estate tax approach as used in Section 2036(c). Although admittedly on a 20 to 30 year perspective an estate tax approach probably raises more funds.

The Discussion Draft has a great many similarities in result to our recommendation. It, like ours, is a gift tax solution with an emphasis on value. We believe a gift tax valuation approach is a desirable one. The Discussion Draft covers three areas which we did not. It covers GRITs which we did not cover because of the statutory exception in Section 2036(c). Limiting such devices to structures similar to those used in the charitable area seems desirable. Joint purchases, other than of residences are included in the Discussion Draft. We did not view this as a problem area, but it may be that they would be used more if they were not limited. The limitation of joint purchases seems reasonably closely related to GRITs. We have technical comments on both of these areas and believe that it would be clearer if they were dealt with separately from corporations and partnerships. The third area included in the Discussion Draft is buy-sell agreements and rights of first refusal, if held by family members. We are opposed to legislation in this area. We believe that the existing regulation issued prior to enactment of Section 2036(c) which prevents the use of buy-sell agreements as substitutes for testamentary devices is adequate to deal with any abuses in this area. Buy-sell agreements in our experience are usually used for matters unrelated to reducing value and thus the legislation is intrusive into an area where there are few problems and it upsets expectation of private parties in ordering the ownership of closely held businesses. Valuing stock for estate tax purposes at more than the price it is sold can also defeat the marital deduction as it will be limited to the proceeds.

The intended results of the Discussion Draft and our recommendation in the corporate and preferred recapitalization area I believe are quite similar. There are two differences in approach. First our recommendation attempts to define what is bad and not consider it in the valuation. The Discussion Draft defines what is good and values everything else at zero. If we were sure our definitions exactly met, the results would be the same. The legislation applies to a very broad area involving any dealing between owners and their closely held businesses. We have already discovered some eighteen areas in which the Discussion Draft, we believe, unintentionally applies. We are more concerned that we will not think of all of the possible transactions that it might apply to and that innocent transactions may be caught. This is particularly a problem when we are deviating from the normal willing-buyer willing-seller valuation rules. We thus prefer to define when we are deviating from such a rule. We understand the argument that the government can also be concerned that it may not be able to list all the rights that are bad and the burden should be placed on the taxpayer to avoid the unintended areas, since the taxpayer can devise the transaction. We believe that when we are dealing with such a large universe our approach would

create less problems. Nevertheless we have attempted to evaluate and comment on the approach of the Discussion Draft.

The second major difference in approach is the taxation of unpaid dividends as a gift. This result is derived from the concept of valuation of a QFP as if all dividends are paid. Whereas dividends may not be paid because of estate tax avoidance objectives they also may not be paid because of changes in the economic fortunes of the company. The imposition of gifts in the latter case is not justified and may not be based on any value being derived by the recipient. In the case where the corporation can pay the dividend and fails to do so, a gift tax may be imposed under pre-Section 2036(c) law. Again the issue is one of whether the law unjustifiably taxes some taxpayers or whether some may slip through the transfer tax system.

The Discussion Draft also considers leases and indebtedness. These we did not consider as they have not given rise to abuse and other sections address them if they differ from fair market value. We oppose including them.

We are also concerned with the complexity of the Discussion Draft. We have been told that our proposal would have been more complicated. We would have thought it could have been easily done by providing for valuation without considering the discretionary rights of liquidation, conversion or put rights without the elaborate system of valuation upon subsequent transfers, and deemed dividends.

We believe the approach of defining what is permitted is bound to lead to omissions. There are a number of situations which the statute seems to cover which it is believed were not intended to be covered. We think it likely that your staffs, upon consideration of these issues, are likely to be willing to recommend appropriate modification. They are described in detail in Exhibit B and merely listed here:

1. Income to child for life then to grandchild treated as a gift entirely to grandchild.
2. General and limited partnership interests that are otherwise identical.
3. Transfer to trust with income 10 years to child and then to grantor, treated as a gift of the entire interest.
4. Partnership with first \$1,000,000 of cash flow to parent may not be able to elect to be a QFP.
5. Only part of preferred and common owned by parent, the extent of gift is unclear.
6. Only part of preferred and common owned by parent and dividend not paid; the amount of the gift appears to not consider common held by others.
7. If give preferred first and then common, pay gift tax on value of preferred twice.

8. If dividends on preferred have cumulated to exceed total value of corporation, amount subject to tax at death may exceed total value.
9. Preferred left to QTIP trust for spouse; makes the spouse the transferor and thus subject to gift tax.
10. Application of Section 2701(d)(5) is unclear and could be interpreted to result in gifts of unintended amounts.
11. Insolvency exception needs to consider debt owed transferor.
12. Buy-sell agreement should impose tax on purchaser of stock.
13. Purchase pursuant to qualified buy-sell agreement but resell to third party at same prices seems to disqualify buy-sell agreement.
14. Buy-sell provisions do not appear to consider that stock may be owned by nonfamily members.
15. Charity should not be a potential family member or limits on split interest trusts for charity have been undermined.
16. Nonfamily member should be considered a family member only if the gift to which chapter 14 is applicable would otherwise be a gift.
17. Joint purchases could be read as requiring double inclusion because of Section 2036(a).
18. Joint tenancy purchase of parent and child might be covered.

There are a number of other situations in which the statute probably intended to cover but we believe should not be covered. We would hope that after reflection, appropriate changes can be made. These situations are described in detail in Exhibit C and summarized below.

19. Percentage lease with parent.
20. Percentage lease with third party but parent has 10% interest in lease.
21. Parent buys third party percentage lease.
22. Guaranteed debt.
23. Demand loan without interest results in deemed gift and no refund when repaid.
24. Parent's deferred compensation with life contingency.
25. Partnership equivalent of cumulative preferred does not meet test of QFP.
26. Family holder of retained interest is incapacitated.
27. Should permit election in of more transactions.
28. Publicly traded preferred should be exempted.

29. Deemed gift rule should have a requirement of at least 50% ownership of common.
30. Transferor for the deemed gift rule should only include individuals in a generation older than the holders of common.
31. Requirement of review of Buy-Sell Agreement should be eliminated, if formula is in fact reasonable.
32. Define what a review is supposed to be.
33. Not following buy-sell value when stock is sold at that value reduces the value of the marital deduction.
34. Ignoring the difference between face value and cash surrender value in insurance for valuation should be permitted.

We believe certain basic changes should be made in the coverage of the Discussion Draft.

A. Leases should not be covered. They are not a device to engage in freeze transactions. If the rental rate is too high or too low, it may have gift tax and income tax effects. It is difficult to conceive of discretionary rights in leases. Contingent rights, such as percentage leases are quite common.

B. Similarly, loans should not be covered. Section 7872 already adequately deals with loans at below market rates. It is not possible to deal with debt in the same manner as preferred stock; there is not an equivalent of noncumulative dividends for debt.

C. The provisions of Section 2702 should be eliminated. Buy-sell agreements are seldom used as estate tax avoidance devices. The existing regulations adequately prevent buy-sell agreements from being used as a testamentary device. Buy-sell agreements are often used for obtaining liquidity and preserving ownership of a business. If the interest is sold for a lower value than the amount ultimately determined for estate tax purposes, it can raise havoc, if there is a marital or charitable deduction.

D. The requirement that nontransferors holding QFP must elect is filled with mischief (i.e. incapacitated parties, accidental failures, family disagreements). The transferor should be permitted to elect for them and be subject to the deemed gift tax.

E. Deemed gifts for failure to pay dividends on preferred should not apply if the holder of the preferred and common are in the same generation. Such a failure to pay dividends does not create a transfer tax advantage and is likely due to adverse business developments.

F. Deemed gifts for failure to pay preferred dividends should only apply if 50% or more of the common is held by family members. If half or more of the benefit is going to nonfamily members it is obviously not an estate planning vehicle. The failure to pay is a result of adverse economic conditions.

G. Any interest should be able to elect QFP treatment. The basic concept of the statute is to permit transactions as long as they are properly valued and to provide for a gift tax if they are not made. Thus no abuse is possible by electing to treat the interest as a QFP. This may take care of a number of interests that would otherwise be unjustifiably caught. This can be a particular problem in partnerships.

The following are suggestions for drafting clarification:

35. Corporation has preferred stock with a value of \$1,000,000 and common stock with a value of \$200,000. Parent owns 20% of preferred and 30% of common. Parent gives 10% of common to child. Value should be computed by adding equity (\$1,000,000 plus \$200,000) taking 20% of it (\$240,000) and then taking its "proportionate share" of the result. Its proportionate share should be 10% or \$24,000. What it is a proportionate share of is not clear. SUGGESTION: After "proportionate share" insert "of the class of interest transferred." §2701(a)(3).
36. Is it intended that §2701(b)(1)(A)(i) not apply to trust? SUGGESTION: If so, substitute for "Except as otherwise provided in this subsection" the words "except for trusts".
37. Presumably §2701(b)(3)(B) requires consent of non-transferor in case of all QFP's. Because of structure of statute it is unclear. It is suggested that the heading of §2701(b)(3) be changed to make the point clear.
38. Partnership formed, parent receives the first \$1,000,000 of cash flow and thereafter 40% of cash flow and child 60% of cash flow. Parent makes election and certain designations as to when such cash flow will be received pursuant to §2701(b)(4)(A). The dates designated are not met by more than three years. Arguably this does not help in avoiding a gift as the valuation rule applies not to elected amounts but those provided in the instrument. See §2701(a)(2)(B)(i). It is likely that the election provision would be interpreted to be the manner of valuation. The taxpayer might then argue there was no deemed dividend because the provisions of §2701(c)(1) only applies to a "specially valued retained interest". §2701(a)(2) and §2703(e)(2). SUGGESTION: In §2701(a)(2)(B)(i) insert "or as provided in any election made pursuant to §2701(b)(4)(A)."
39. Corporation A has preferred stock held by parent. Sixty percent of the common stock of Corporation A is owned by Corporation B; remainder of common stock owned by third parties. Parent owns 20% of Corporation B and gives common stock to child. Rest of stock of corporation B owned by third parties. Statute should apply as stock owned by corporation B should be attributed to its shareholders in proportion to their holdings, resulting in parent being deemed to own 12%, which is more than the 10% requirement. SUGGESTION: Provide in §2703(b) that stock owned by an entity shall be treated as owned by the stockholders, partners, or beneficiaries in proportion to their interest in the entity.

40. The statute would be more understandable if trusts and joint purchases were dealt with separately from corporations and partnerships. There are a number of special rules relating to them. It is understood that all that is being affected are GRITS and Joint Purchases. It would be much clearer if this were done directly rather than purportedly to apply to all trusts and then create exceptions.
41. All definitions should be placed in one section.
42. Definitions of interests in an entity would be helpful.
SUGGESTION: Interest should be limited to ownership of a portion of the equity.

EFFECTIVE DATE: We recommend that different effective dates be considered for different parts of the statute. Areas which the Discussion Draft treats more harshly than the current Section 2036(c) should not become effective prior to enactment. These include statutory GRITS, proportional transfers and interests held by family members.

CONCLUSION: We strongly favor prompt repeal of Section 2036(c). If the changes we have suggested are made, although we prefer our Task Force approach, we can support adoption of the Discussion Draft, because of the urgency in repealing Section 2036(c).

We would be pleased to work with the appropriate staffs to develop language to accommodate our various technical and substantive points.

EXHIBIT A

TESTIMONY OF JERE D. MCGAFFEY
ON BEHALF OF THE SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

on

"Discussion Draft" relating to
Estate Valuation Freezes
House Ways and Means Committee
April 24, 1990

REPORT OF THE SECTION 2036(c) TASK FORCE

Prepared by a Task Force of the ABA Section of Real Property, Probate and Trust Law, Section of Taxation, and The American College of Probate Counsel.

The Task Force recommends that Section 2036(c) be repealed and an alternative legislative response to the "estate freeze" problem be substituted for it.

The Task Force has analyzed the transfer tax avoidance problem which Section 2036(c) was attempting to address and proposes certain legislative alternatives in order to deal with this problem. The Task Force is mindful of the concern for adequate enforcement of the estate and gift tax laws and the limited resources available for this purpose. Its proposals, therefore, recommend substantive changes in the estate and gift tax law, rather than merely urging more stringent enforcement efforts by the Internal Revenue Service. The Task Force is also mindful of revenue concerns. To the extent there are any significant revenue implications, the Task Force proposals should increase revenue in the short term, because the emphasis of the proposals is on the gift tax payable at the time of the transaction rather than on the estate tax payable on the transferor's later death.

THE PROBLEM: The Task Force believes the "estate freeze" problem was one of valuation. In the classic case of a preferred stock recapitalization, the common stock was valued by subtracting from the value of the business the value of the preferred--typically valuing the preferred at face although it did not bear a cumulative dividend at a market rate. Instead, various "features" were included in the preferred to justify a valuation at face. These features were usually rights given to the holder to protect the economic position of the preferred stockholders that were not expected to be exercised. Further, the transaction was often not reported as a gift. Consequently, neither the initial transaction nor the later failure to pay dividends were drawn to the attention of the Service for audit.

Some have suggested that there are other policy reasons for having Section 2036(c). These have yet to be clearly articulated. They seem to relate to the concept of retention of "strings." Such a rationale is consistent with Section 2036(a) (retention of the "string" of income) and Section 2036(b) (retention of the "string" of voting). "Strings" may include the extension of compensation, interest on loans, and lease payments. To the extent these payments are only reasonable and adequate compensation for services rendered, market interest rates, and arm's length rental payments, they are not retained "strings" on the gift of capital, but instead represent quid pro quo payments in exchange for valuable rights. To the extent such payments are excessive (note this problem is the opposite of the valuation problem in a preferred freeze where the dividend is inadequate),

various income tax sections and doctrines (e.g., unreasonable compensation and Section 482) can adequately deal with any problems. To the extent the "string" retained is the preferred dividend, this issue is a valuation issue.

If the "string" retained is the control of a closely held enterprise because of the ability to obtain various benefits from the enterprise, the definition of "string" is too broad. Such a definition would logically apply to all gifts of any minority interest in a closely held enterprise. Tax policy should not unduly discourage the closely held business owner from transferring part of an interest to the owner's children during the owner's lifetime.

PROPOSAL

PART 1 VALUATION ASSUMPTION: For gift tax purposes only, nonpublic stock and partnership interests shall be valued in order to maximize the value of the gift by assuming any discretionary liquidation, conversion, dividend or put rights retained by the donor or the donor's spouse will not be exercised by them in a manner adverse to the donee's interest if the donee is a member of the donor's family.

This proposed valuation assumption rule is confined to nonpublic corporation and partnership interests because the past "estate freeze" abuses have occurred with respect to interests in business entities and there is no potential for valuation abuse with transfers of publicly traded interests. The attempt in Section 2036(c) to encompass all "enterprises" caused great uncertainty as to the limits of that Section's application. The Section 2036(c) requirement of a 10% interest indicates the intent to apply the current "estate freeze" limitation only to business entities. If there is more than one person interested in an enterprise, it will be conducted either in corporate or partnership form.

In recapitalizations, the common stock was often valued by assuming that the discretionary conversion, liquidation or dividend rights of the retained preferred stock would be exercised in a manner which would be disadvantageous to the common stock owner. However, in many cases the donor was not likely to exercise those discretionary rights to the disadvantage of the donee's interests.

The proposed gift tax valuation assumption rule is intended to value the transferred common stock interest without lowering that value with the discretionary "bells and whistles" often placed on the preferred. Thus, a cumulative preferred dividend would decrease the value of the donated common stock for gift tax purposes because such right is not discretionary, but a noncumulative dividend rate would not decrease the value of the transferred common stock for gift tax purposes as there could be no assurance it would be paid.

This change in the substantive law of valuation would mean that a taxpayer could not claim compliance with the law by use of "bells and whistles." The discretionary rights listed are intended to include all rights which may be used in aggressive recapitalizations or other potentially overreaching transactions. It is not intended to make any change in pre-1968 law with respect to voting rights. It, therefore, does not propose to change the law as to valuation of nonvoting or minority stock.

The Service has attempted to challenge these devices by treating noncumulative preferred dividends not paid in any one year as a gift under the rationale of the Dickman case. See Ltr. Rul. 8403010; TAM 8723007; and TAM 8726005. This proposed valuation rule, the Task Force believes, is a more effective deterrent to such transactions than attempting to tax each year's failure to exercise the rights as gifts. The proposal is similar to Section 7872 which, when dealing with term loans, treats the gift as made at the time the loan is made, not annually. Also, if the gift is deemed made annually, annual exclusions may diminish the effect.

Public corporations or partnerships might be defined as those for which market quotations are readily available on an established securities market. This definition accords with that in Section 170(e)(5)(B)(i) relating to charitable contributions of qualified appreciated stock.

The proposed valuation assumption rules would have no application to nonfamily transfers. It is suggested that "family" be defined as issue of the donor or the donor's spouse and spouses of such issue.

PART 2--A SAFE HARBOR: For purposes of valuing any gift of a junior or residual equity interest in a nonpublic corporation or partnership ("common interest"), which interest is subject to one or more senior or preferred equity interests in such corporation or partnership ("preferred interest"), any such preferred interest shall be deemed to have a value not less than the amount which such preferred interest would receive if the corporation or partnership were liquidated on the date of such gift ("the liquidation amount"), provided that

(a) such preferred interest is entitled to a cumulative dividend or preferred income right not less than the liquidation amount multiplied by the applicable Federal rate on the date of such gift determined under IRC §1274 compounded semiannually; and

(b) in the event of any failure of the corporation or partnership to pay dividends or make cash distributions in the amount stipulated in (a) above for 36 months, the preferred interest shall be entitled to voting control of the corporation or partnership; and

(c) the sum of all such preferred interests does not exceed 80% of all of the equity interest in such corporation or partnership.

Through the concept of qualified debt and qualified start-up debt in Section 2036(c), Congress has authorized a division of the capital structure of a nonpublic corporation or partnership into debt and stock. There are, however, many situations where a preferred stock or preferred partnership interest would be preferable either as a substitute for debt or in addition to debt. The Task Force believes that such preferred interests should be authorized if there are adequate provisions against valuation abuses. Congress has authorized use of the applicable Federal rate for the valuation of debt for gift tax as well as income tax purposes, even though the credit of the individual or nonpublic business is certainly less than that of the Federal government and thus a higher interest rate would be economically justified. The Task Force is of the view that it would create unnecessary administrative complexity to use varying rates for different types of debt and equity interests. Therefore, we suggest use of the applicable Federal rate for any preferred interest, whether it be debt, stock or a preferred partnership interest.

Safe harbors have an advantage in obtaining compliance. The experience of practitioners is that many taxpayers will structure their transactions to fit within them, if they are reasonable.

It is essential in defining a safe harbor preferred to provide that the preferred returns are cumulative. An outsider would purchase a preferred stock which was not cumulative only in rare and unusual circumstances. Although the cumulative feature of preferred is normally not compounded, compounding is believed desirable in the family context. In the nonfamily context, other factors assure payment of dividends. In the family situation, even cumulative dividends may well not be paid. If the rate does not compound, a significant advantage to the common interests can be obtained. The recent emphasis on "time value of money" indicates the wisdom of including compounding. Furthermore, the market is utilizing paid-in-kind preferred dividends in the case of highly leveraged enterprises to obtain the compound effect. A paid-in-kind provision should be considered as satisfying the compounding requirement.

The dividend or compounding rate selected is the relevant applicable Federal rate. Usually the long-term Federal rate would be used, but if it is a preferred with a variable or reset rate provision, the short or midterm rate may be appropriate. Taxpayers should be able to elect the rate from any one of a specified number of months before the gift in view of the time required to plan and effectuate the transaction.

If all the value of a corporation or partnership is placed in the preferred, no matter what the dividend rate, it understates the value of the common. The common always has at least the value of an option that may obtain value if the business does better than the return on the preferred. Therefore, some minimum capitalization in common stock should be required. The Task Force believes that requiring at least 20% of the equity capitalization to be in common stock or non-preferred partnership interests should solve this problem.

The interest rate and capitalization requirement must be met at the time of gift rather than just when the preferred is issued. This limits the safe harbor's usefulness in the case of annual gifts. However, consideration should be given to valuing preferred (that otherwise meets the capitalization requirement) by the use of the applicable Federal rate tables in a manner similar to valuing debt instruments with inadequate interest under the OID rules. The lack of a maturity date for preferred complicates the problem, but this may be dealt with by assuming that preferred stock will be redeemed in 40 years.

A shift of voting control after a 36-month default in preferred contributions is provided to ensure that such a preferred, for estate tax purposes, would have a value equal to its stated liquidation value (including cumulative distributions) adjusted for changes in interest rate, if the corporation's or partnership's assets have at least such value. Because dividends may not be paid, it is important to assure that such value is not diminished. There is considerable question as to whether alternative provisions such as mandated estate tax valuation should be used.

CONCLUSION: It is believed that enactment of the foregoing proposals in place of present Section 2036(c) will permit legitimate business transactions and give the Service the tools necessary to prevent unjustified tax avoidance devices.

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EXHIBIT A-2

EXHIBIT B

TESTIMONY OF JERR D. MCGAFFEY
ON BEHALF OF THE SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

on

"Discussion Draft" relating to
Estate Valuation Freezes
House Ways and Means Committee
April 24, 1990

The following are situations which the statute seems to cover which it is believed were not intended to be covered:

1. Parent gives stock to trust and trust provides for income to child for life then to grandchild. Since member of the transferor's family (child) has an interest it could be argued that the entire amount is a gift to grandchild. SUGGESTION: In defining family interests that are valued, require they be held before and after the gift. Consider whether it is intended to apply if gave common stock to grandchild and preferred to child and also retained some preferred. This problem may be better solved by placing trusts in a separate section.
2. Child has business operated in partnership with parent as limited partner and child as general partner. Child has a 20% interest in all aspects of partnership and parent 80%. Some argue that the limited partnership interest may be deemed to be a preference under Section 2701(a)(2)(C)(iii). SUGGESTION: Insert after "preference" the words "of cash flow or income".
3. Parent transfers stock to a trust with income for ten years to child and remainder to parent (even though parent is taxed on the income the tax is probably at no higher rate than to child). In such a case since the interest is an income interest it is not a QFP and it will be treated as if the entire property is transferred to the child. SUGGESTION: The provision for trust QFP should provide any amount payable under a contingent remainder interest; the qualifying clause should be eliminated. Section 2701(b)(3)(D). There is not any way to cause a freeze if the transferor gets the interest back.
4. Partnership formed and parent receives the first \$1,000,000 of cash flow and thereafter 40% of cash flow and child 60% of cash flow. It appears that such an arrangement could not be elected to be a QFP, as the "sole reason" it was not a QFP is not that it is contingent, but that there is no fixed payment time. This arrangement should be able to be elected in, as, if the timing of payments are not made there would be deemed gifts. SUGGESTIONS: Permit the holder of any partnership interest to elect to treat such item as a QFP. If such a rule is too broad, at least permit the holder of a

partnership interest where the payments are contingent on income or cash flow to elect to have the payment treated as a QFP.

5. Parent owns 30% of the preferred and 30% of the common. The rest of the common and preferred is owned by nonfamily members. Parent gives 10% of common to child. Preferred is a non QFP. What is the amount of the gift? SUGGESTION: value corporation as a whole; subtract 70% of the preferred at its fair market value; take 10% of the result. Note this is not 10% of the value of the corporation as a whole, as that would disregard the nonfamily preferred. I believe the current statute is reasonably clear on this point.
6. Parent owns 30% of the preferred and 30% of the common. The rest of the common and preferred is owned by nonfamily members. Parent gives 10% of common to child. Preferred is a QFP. Dividend is missed on preferred. What is the amount of the gift? SUGGESTION: The purpose of the deemed gift rule is to protect the valuation on the gift and thus should be considered in the same manner as if the preferred was not a QFP. The failure of the parent to receive the gift on the preferred benefits all common stockholders. Thus the gift is 10% of the amount of the preferred dividend not received by the parent or 3% of the total corporation's preferred. The statute is not clear as to how one deals with the deemed gift.
7. Grandparent held cumulative preferred from grandfathered recap and parent held common. Grandfather dies leaving preferred to parent. Parent gives preferred to child A who needs income and pays gift tax. Later parent gives common to child B active in business. Child A refuses to consent. Parent pays gift tax on entire value of corporation even though parent previously paid gift tax on preferred stock. SUGGESTION: The extent of the gift of the common should be reduced by the value of the prior gift of the preferred. Cf. Section 2701(e)(1).
8. Corporation recapitalizes with parent taking preferred stock with compound cumulative dividend at market rate based on liquidation value of \$1,000,000 and common stock; corporation is worth \$1,400,000. Common stock is given to child. Dividends are not paid. Dividends compound to give preferred liquidation amount at time of death of parent of \$3,000,000. Corporation's total value at time of parent's death is \$2,200,000. It is unclear how the value at date of death would be determined under Sec. 2701(d)(2). The rules under Sec. 2701(a)(2)(B) do not value the liquidation right but the right to dividends. If it is just dividends in the future the value is \$1,000,000. If it also includes dividends in the past it would be \$3,000,000. The value without the special rules would presumably be \$2,200,000. There is no justification for valuation above total market for the corporation. Note that the 20% rule assures that the taxpayer has been adversely affected under this ineffective freeze. SUGGESTION: Valuation increase under Section 2701(d) cannot increase value above market value of entire corporation. Legislative history should make clear that QFP includes past unpaid cumulative dividends.

9. Parent dies holding preferred stock with a QFP that is left to a QTIP trust for spouse. There is a possible argument that Section 2701(d)(3) makes the spouse the transferor and thus the transfer to the QTIP trust is subject to the statute treating the spouse as if the spouse transferred to the QTIP which is nonqualifying and thus a transfer to the remainderman. SUGGESTION: Insert before "treated" in line five the word "thereafter".
10. The application of Section 2701(d)(5) is unclear. What is being transferred needs to have more definition. Is it the value immediately before the termination? How does the termination event effect the value? If the transferor retained the right to an annuity payment for 10 years and then in the 10th year it terminates, does the section have some application? In the case of a preferred that is a QFP, if after five years the preferred is called, how does it apply? Is the value of the preferred before the call considered (which would be the future value of the dividend stream) and compared to the amount paid for the preferred? If interest rates had changed so the dividend payment was above market, the value of such dividend payments could exceed the call price; is this intended to be a gift? If so, it seems unjustified as arm's-length parties would call the preferred in such circumstance. SUGGESTION: This provision should be eliminated. If not eliminated, it should be clarified as to what is intended.
11. A corporation has a value of \$1,200,000; parent retains \$800,000 of cumulative preferred and gives away common. A year later the corporation is in financial difficulty and a loan of \$300,000 is made to the corporation by parent for five years at market interest rate. The next year parent makes a \$800,000 loan on similar terms. No dividends are paid on preferred. Corporation has no other creditors and asset value is \$600,000. Corporation is insolvent and there is no reason to make the failure to pay preferred a gift to common. Failure to pay interest should not be a gift (presumably this is not a problem because of compounding). What is effect on liquidation? Does §2701(d)(5) mean that the value of the preferred and debt is treated as a gift as if the payments would all be made? SUGGESTION: In measuring insolvency, transferor debt should be considered. Eliminate §2701(d)(5).
12. Buy-sell agreement was entered into between parent and child A with respect to their stock in a corporation they owned. The price was to be determined by a formula based upon an average of the last three years' earnings times a multiple of 8. Earnings had normally increased a little more than the inflation rate each year. The agreement was entered into 10 years prior to death of parent and never reviewed. Multiples in the industry had moved to 12 four years prior to death. Buy-sell agreement provided for payments over 10 years with interest. Buy-sell value of parent share of corporation is \$2,000,000, the appraisal value is \$3,000,000. Parent had an estate plan leaving property all to child B as child A had received gifts in corporation during lifetime. Child B hates child A and believes child A was always favored. Now child B must pay tax on property going to child A. SUGGESTION: Impose no new limits on

buy-sell agreements. If this is not satisfactory, impose tax on purchaser of stock.

13. A buy-sell agreement was reviewed within three years of death and was reasonable at that time. The purchase was made by the corporation pursuant to the buy-sell agreement and the corporation immediately sold it at the same price to unrelated employees. The buy-sell agreement does not set the price as there was a sale to an unrelated party within six months. Section 2702(b)(3). SUGGESTION: Provide for an exception to the six month sale rule for sales at the same price or pursuant to the same formula as contained in the buy-sell agreement.
14. Corporation has only common stock, 20 shares owned by parent, 30 shares owned by child, 50 shares owned by others. Buy-sell agreement with corporation which provides that stock is to be purchased at a formula price. Formula price is \$10,000 a share fair market value is \$16,000 a share. Buy-sell agreement does not qualify to determine value. It would appear that the stock is valued at \$3,200,000 resulting in an increase in value above the buy-sell agreement of \$1,200,000 even though the benefit to the child is 30/80. SUGGESTION: Impose no new limits on buy-sell agreements. If this is not satisfactory, impose limits only when the other family members receive over 50% of the benefit. If neither of these alternatives are satisfactory, have the increase in value limited to the benefit to family members.
15. Section 2703(a)(2) treats any person as a member of the transferor's family if the transfer would otherwise be considered a gift. SUGGESTION: Charity should be eliminated from this definition. Otherwise the gift of income to charity for 10 years, remainder to the donor would result in the entire value of the property be deemed to go to charity. All of the limitation of annuity and unitrust in limiting the charitable deduction would be eliminated (or at least made inconsistent with this chapter--presumably this chapter overrides provisions in Chapter 11, 12 and 13).
16. Section 2703(a)(2) treats any person as a member of the transferor's family if the transfer would otherwise be considered a gift. It is unclear for what purposes this applies: e.g.:
 - a. If parent has preferred and common and gives common to niece statute applies.
 - b. If parent has QFP preferred and gives common to niece and dividend is not paid presumably statute applies to impute a dividend.
 - c. If parent gives in year one a car (a cut glass bowl, a watch, a savings bond) to niece and in year two sells (or the corporation sells) niece common stock for full and adequate consideration, does the statute apply?

SUGGESTIONS: Section 2703(a)(2) should treat a nonfamily member as a family member only for purposes of the particular gift and the deemed gift consequences that subsequently flow from it not, as if, there had been a permanent adoption. Applying the statute to a situation as in (c) would place a heavy burden in normal transactions to determine all past

possible gifts and can be reduced to the ridiculous as the cut glass bowl example illustrates.

17. Parent and child make a joint purchase of income producing real estate. The purchase price is \$1,000,000. The tables provide the parents value to be \$600,000 and the child's value is \$400,000. The application of Section 2703(d)(2) is unclear. Under the most extreme reading the parent is deemed to have acquired it for \$1,000,000 and transferred the interest to the child. The parent's interest not being a QFP would mean the parent was deemed to make a \$1,000,000 gift. Furthermore, such gift could cause the property to be included in the estate under Section 2036(a) or \$1,000,000 could be taxed as a gift and \$1,000,000 included in the estate when the parent only spent \$600,000 and received a life estate. SUGGESTION: The amount of transfer should be reduced by the consideration paid by the transferee. The recasting of the transaction as a purchase of the entire property and a gift should only apply for purposes of Chapter 14 so that Section 2036(a) does not apply. Chapter 14 or Section 2036(a) should apply but never both.
18. Parent and child purchase property as joint tenants with rights of survivorship. Is this a gift of the entire amount to the child? The issue is whether or not the parent has a life interest. Section 2703(d)(3) State laws vary in this regard and some treat it in such a manner. SUGGESTION: Create an except for joint tenancy with right of survivorship.

EXHIBIT C

TESTIMONY OF JERE D. MCGAFFEY
ON BEHALF OF THE SECTION OF TAXATION
AMERICAN BAR ASSOCIATION

ON

"Discussion Draft" relating to
Estate Valuation Freezes
House Ways and Means Committee
April 24, 1990

The following are situations which the statute probably intended to cover but we believe should not be covered:

19. Business is a retail concern operated in a corporation with real estate rented from shareholder. Parent owns all the stock of the corporation and real estate. Parent is retiring from business, child is to operate business. Parent gives all of the stock to child. Lease on real estate is based on a percentage of receipts. Leases are considered an interest in the corporation and the lease is not a QFP. Presumably this would mean that the valuation of the corporation, if based on earnings, has to be adjusted by eliminating any rental expense and, if valued based on assets, presumably the real estate is included for at least the period of the lease. What if the lease is automatically renewable for year-to-year? Unless the parties give notice of termination, what is the value included? A percentage lease in such circumstances is the norm. In fact any other type of lease might be considered not at arm's-length and involve a gift under other sections of the code. It is difficult to understand what type of lease could involve the valuation abuses that are of concern. It is hard to imagine any discretionary rights in a lease. Percent of sales rent is a right that should be valued in the case of a lease. SUGGESTION: Leases should not be considered an interest in the entity. If considered, the payment stream, however contingent, should be an amount that can be elected as a QFP.
20. Business is a retail concern operated in a corporation, all owned by parent. Parent leases space from third party with contingent rental based on sales. Because of importance as a tenant parent receives a 10% interest in the real estate. Parent gives some of common stock to child. Presumably 10% of the real estate adds to the value. SUGGESTION: Lease should not be considered an interest. If considered, the ownership requirement in the property leased should have to be at least as great as the transferor's ownership interests in the entity.
21. Business is a retail concern operated in a corporation owned by child. Third party leases real estate to corporation with a rental based on sales. Parent buy's real estate from third party and continues prior lease. Treated as a gift by parent of real estate to child. SUGGESTION: Lease should not be considered an interest.

If considered, the payment stream, however contingent, should be an amount that can be elected to be a QFP.

22. It should be made clear whether indebtedness includes third party debt that is guaranteed by the transferor or a member of the transferor's family. The significance of this question is both for the interest in the entity under Section 2703(e)(3) and for determining the minimum 20% junior equity. Section 2701(a)(3). The question could be answered differently in both cases. Presumably, if it is third party guaranteed debt, adequate interest has been charged so that as a QFP it will be valued equal to the funds loaned. However, if it had an equity kicker such as a conversion feature or warrants this would not be the case. In such situation, if the principal was guaranteed, a transfer might be deemed to occur. The consequence of failure to pay interest on a guaranteed debt would usually be exempt under the insolvency exception. If the guarantor paid interest to the third party, the guarantor would be subrogated to the rights of the third party and thus an indebtedness would be created between the entity and the guarantor. In the case of the minimum 20% junior equity requirement, if guaranteed debt is included the inclusion of transferor debt may in large part include all debt. As in many small corporations all third party debt has to be guaranteed. Such an interpretation greatly changes the relationships and would be too severe a limit. SUGGESTION: Indebtedness should not include guaranteed debt until the guarantor has had to pay on the guarantee, at which time, it is direct indebtedness.
23. Parent owns 60% of corporation and child 40%. Only one class of common stock. The corporation is in need of funds. Parent makes demand loan without interest to corporation. Amount repaid two years later. Gift of imputed interest is provided in Section 7872. (See Proposed Regulation 1.7872-4(g)). However, since a loan is a capital contribution that is an interest in the entity it would result in a gift of the principal. The actual payment would not be a QFP and thus not give rise to a refund. SUGGESTION: Loans should not be interests in an entity. If loans remain an interest, they should be able to elect to be QFPs. Whether or not elected, the repayment of principal should give rise to a refund for prior gift.
24. Parent and child own stock in a corporation. Parent receives deferred compensation agreement that provides a life contingency. Presumably this is to be valued at zero and is treated as an indebtedness which is an interest in the entity. In some manner this would effect value resulting in some gift. SUGGESTION: Indebtedness should not be an interest in an entity. If it is an interest in an entity, it should be limited to indebtedness for money advanced.
25. Partnership is formed with parent contributing \$1,000,000 and having the right to \$100,000 each September 30th provided the partnership has adequate cash flow to make the payment and, if not, the amount will be accumulated for payment later. Child owns an interest in the partnership received in exchange for \$300,000 which receives all cash flow after all required payments are made to parent. Although this is equivalent to a preferred stock dividend it does not qualify as a QFP as payment with respect to a partnership must be fixed

as to time. §2701(b)(1)(A)(i). It presumably could be an elected QFP. §2701(b)(4)(B)(ii). SUGGESTION: The provisions for partnerships should be made parallel to that of corporations. This interest should qualify as a QFP. This could be accomplished by moving the language in §2701(b)(4)(B)(ii) to §2701(b)(1)(A).

26. Grandparent owns preferred. Parent owns common. Parent gives some common to child. Grandparent is incapacitated. Statute requires that a guardian be appointed for the purpose of making the election. Family may be reluctant to go through the expense for this purpose or the guardian may be unwilling to elect because it can only be detrimental to the party electing. Parent expects all payments to be made on preferred. SUGGESTION: Permit transferor to elect for anyone else who owns a QFP, if transferor is liable for any subsequent gift tax.
27. The basic concept of the statute is to permit transactions as long as they are properly valued and to provide for a gift tax if the amount is not paid. The structure of the statute deviates from the normal rule of valuation of "willing buyer and willing seller" and imposes an extremely harsh rule of valuation at zero if one does not fit within certain defined provision of a QFP. Since it applies to all transactions involving family members it is doubtful that all of the possible situations have been considered. SUGGESTION: Permit any interest to be a QFP, if an election is made as to the amounts to be paid. The revenue is adequately protected. The taxpayer would then be protected in the event there is interest no one has considered. It is unlikely that there will be many of these situations and they will impose a difficult burden. If there are a lot it demonstrates that the statute is defective as we have not thought of all the situations to which it applies. At a minimum, permit the election in of any partnership interest no matter what the nature of the contingency, GRIT's and joint purchases.
28. Parent owns over 10% of common in publicly traded corporation, as well as some publicly traded preferred. Parent gives some common to child. Because corporation has financial difficulty cumulative preferred dividend is not paid. This would constitute a gift although because of the public market there was no assumption as to the value of the preferred in valuing the common and the failure to pay the dividend on the preferred was not tax motivated. SUGGESTION: Publicly traded preferred should be exempted.
29. Corporation is not publicly held. Parent owns 40% of preferred and 20% of common and gives 10% of common to child. Corporation due to economic problems and covenants in its bank loan agreement does not pay preferred stock dividend. Since more than half the dividends would be paid to nonfamily members, it is clear the failure to pay dividends is not tax motivated. SUGGESTION: The ownership level for the deemed gift rule should be raised to at least 50% of the common. Note that since the preferred must be cumulative the only disadvantage to the government (advantage to the taxpayer) is the time value of money issue.

30. In the past, grandfather left common stock 50% to parent; 25% to child A and 25% to child B. Child A has been running the business and collecting a salary. Child B wants income from corporation. Parent wants to become less active in business. Corporation is recapitalized. Parent and child B exchanges their common for cumulative preferred. Child B elects in. The corporation has financial problems and does not pay the dividend. Whereas imposing a gift tax on parent may be justified, it is not justified to impose a gift on child B who already has suffered the failure to receive dividend. The concept of a freeze is to have the frozen interest in the older generation. SUGGESTION: The transferor for the deemed gift rule should only include individuals in a generation older than the holders of common.
31. Buy-sell agreement was entered into between parent and child with respect to their stock in a corporation they owned. The price was to be determined by a formula based upon an average of the last three years' earnings times a multiple of 8. Earnings had normally increased a little more than the inflation rate each year. The agreement was entered into 10 years prior to death of parent and never looked at. An 8 multiple was reasonable for the industry until the year prior to death when the industry became very popular with the stock market and a 12 multiple was more appropriate. The child bought the stock from the parent's estate at the buy-sell agreement amount and did not sell the stock. Under the statute the buy-sell agreement will not qualify and a higher value will be used in the estate and yet if a review three years earlier occurred it would have qualified. SUGGESTION: Impose no new limits on buy-sell agreements. If this is not satisfactory, the requirement of a review be eliminated. If at any time during the period three years prior to death the agreement was reasonably expected to produce a price which would approximate the fair market value of such property as of the time of such sale, the buy-sell agreement should be considered in valuation.
32. Buy-sell agreement was entered into between parent and child with respect to their stock in a corporation they owned. The price was to be determined by a formula based upon an average of the last three years' earnings time a multiple of 8. Earnings had normally increased a little more than the inflation rate each year. The agreement was entered into 10 years prior to death of parent. Two years prior to death the attorney who drafted the agreement looked at the buy-sell agreement, the appraisal used in determining the formula, and comparable publicly traded corporations and concluded it was adequate. An 8 multiple was reasonable for the industry until the year prior to death when the industry became very popular with the stock market and a 12 multiple was more appropriate. The child bought the stock from the parent's estate at the buy-sell agreement amount and did not sell the stock. It is unclear what formalities are required in such review. What if the parent had reviewed it and determined it adequate; what evidence must there be of such review? What if the parent was incapacitated? SUGGESTION: Impose no new limits on buy-sell agreements. If this is not satisfactory, the requirement of a review should be eliminated. If at any time during the period three years prior to death the agreement was reasonably expected to produce a price which would approximate the fair market value

of such property as of the time of such sale, the buy-sell agreement should be considered in valuation.

33. Buy-Sell Agreement was entered into between parent and child with respect to their stock in a corporation they owned. The price was to be determined by a formula based upon an average of the last three years' earnings times a multiple of 8. Earnings had normally increased a little more than the inflation rate each year. The agreement was entered into 10 years prior to death of parent and never reviewed. Multiples in the industry had moved to 12 four years prior to death. Buy-Sell agreement provided for payments over 10 years with interest. Buy-sell value of corporation was \$2,000,000 the appraisal value was \$3,000,000. Parent had an estate plan leaving property all to spouse (had made \$600,000 of gifts to child during lifetime). Parent had purchased two-life insurance to fund estate tax liabilities paying off at the last to die of both parents. Under this set of facts, the estate will be \$3,000,000 and the marital deduction only \$2,000,000, resulting in tax on \$1,000,000 with no funds to pay. Since the funds will reduce the amount going to the marital deduction if the average rate is 40%, it will need to reduce the marital deduction another \$666,000.
SUGGESTION: Impose no new limits on buy-sell agreements.
34. The buy-sell agreement between shareholders and the corporations provides for a formula arriving at a reasonable price except for the fact that it treats insurance on the decedent as valued at cash surrender value rather than face value. The agreement is reviewed within three years of death and the purchase is made pursuant to the agreement. This provision is typical in arms-length agreements in order to avoid having to purchase additional insurance in the corporation because of the added value which the insurance provides.
SUGGESTION: Impose no new limits on buy-sell agreements. If this is not satisfactory, include a provision similar to "the price determined under an option (or agreement) or formula shall not be considered to be less than fair market value by reason of ignoring the difference between the proceeds of a life insurance policy and such policy's cash surrender value."

STATEMENT OF E. JAMES GAMBLE, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE, AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL, ACCOMPANIED BY WALLER H. HORSLEY, PRESIDENT, AND THOMAS P. SWEENEY, VICE PRESIDENT

Mr. GAMBLE. I am James Gamble, an attorney practicing in Detroit, MI.

I appear in my capacity as chairman of the Estate and Gift Tax Committee of the American College of Trust and Estate Counsel.

With me are Waller Horsley of Richmond, Virginia, president of the college and Thomas Sweeney of Wilmington, DE, who is vice president of the college.

We want to express our appreciation to the committee for the process you have provided us in making the discussion draft public and for permitting us to examine it, prepare comments and to submit the comments to you this morning.

The college supports the committee's effort to stop abusive valuation freezes. We support the approach used in the discussion draft in treating this as a gift tax valuation problem.

We wholeheartedly support the proposed repeal of section 2036(c) because we think that has been a disaster by and large and is bad legislation that should be repealed. We do feel that chapter 14 is too broad and complex. And we prefer the joint task force report that Mr. Wallace and Mr. McGaffey described to you because that would be simpler and less intrusive in the everyday affairs of small businesses than chapter 14.

I want to give you three examples of what we perceive to be some of the particularly complex areas raised by chapter 14. The first is that it applies to people who do not control the small businesses. Its threshold of 10 percent ownership is exceedingly low. People who own only 10 percent of a business are not in a position to engage in abusive freezes. They do not control the business. They also do on occasion, however, lend money to small corporations in which they own property. They also lease property to it, and this bill would impose upon them the burden of trying to determine each time they want to make a gift of common stock to a member of their family whether or not they are subject to the provisions of this act.

It will require them to bring in a battery of lawyers and accountants to analyze it for them. It will be extremely costly. They may decide chapter 14 does or does not apply. It is just not worthwhile to make chapter 14 apply to people who are not the controlling forces behind the corporations.

Chapter 14 would also apply to people who own more than 10 percent of an interest in a publicly owned corporation. These people, again, do not control the course of the publicly owned corporation.

There seems to be no useful point in applying chapter 14 to them because they just are not in a position to install an abuse valuation freeze, which is what this is all about, in a publicly owned corporation.

Secondly, the discussion draft ignores the fact that market values may be readily available to be used for gift tax purposes.

The whole purpose of section 2701 is to provide a mechanism for determining the value of common stock that is given away.

When that common stock is in a publicly traded corporation, there is no necessity to go through this process. Yet, under the bill, you would have to go through the special rules, come up with a value that probably would be different than that for which people are buying and selling the stock on an everyday basis and use that for gift tax purposes.

It makes no sense whatsoever to do that.

There is another area in which a fair price is readily available, but the statute would not recognize the availability of it nor sanction its use. That is in the context of a sale by the principal owner of the common stock he owns to a management team who will succeed him, most of whom are people who are not members of his family, but that does include one or two members of his family.

He may negotiate at arms length for days and weeks to come up with a fair price, then sell the common stock to the management team. It will be treated like an arm's-length transaction insofar as those people who are not family members are concerned, but selling it for the same price to his own children will cause him to be in a situation in which he may have to pay a gift tax. There is no rhyme nor reason to that kind of arrangement.

My last example involves what I refer to as the adoption by gift rule. The statute provides, for example, that if you are the principal owner of a corporation and your sales manager decides to get married and you buy him a wedding present, your sales manager becomes a member of your family. Why is that?

We are unable to determine why that rule is in the discussion draft. But if the sales manager along with other unrelated employees is receiving stock bonuses or is under a program in which he can buy stock from the corporation from time to time, he will be treated as a member of the principal owner's family and possibly subject the principal owner to a gift tax because the sales manager buys or receives stock from the corporation in what is otherwise a routine transaction.

That ends the examples I want to put before you. There are many more in our written statement. We appreciate very much having the opportunity to appear before you today.

Thank you.

[The statement of Mr. Gamble follows:]

STATEMENT OF E. JAMES GAMBLE ON BEHALF
OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL
AT A HEARING ON THE DISCUSSION DRAFT RELATING TO
ESTATE VALUATION FREEZES
BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
April 24, 1990

Mr. Chairman and Members of the Committee:

My name is E. James Gamble, and I am a tax and estate planning lawyer who practices in Detroit, Michigan. I am pleased to be here today on behalf of the American College of Trust and Estate Counsel with my colleagues, Waller H. Horsley and Thomas P. Sweeney, who are, respectively, the President and Vice-President of the College. I represent the College in my capacity as the Chairman of its Estate and Gift Tax Committee and of its Section 2036(c) Task Force.

The membership of the College is composed of more than 2600 lawyers who specialize in the practice of trust and estate law and related tax matters. A major and continuing effort of the College since it was organized over 40 years ago has been the improvement and reform of probate and transfer tax laws with the ultimate goal of simplifying the disposition of property and the administration of estates in this country. The College is grateful for the opportunity to appear before this distinguished Committee to express its views concerning the repeal of Section 2036(c) and the Discussion Draft containing the proposed new Chapter 14. We welcome and accept once again the challenge of working with the Congress to find additional ways to improve and simplify the nation's transfer tax laws.

THE COLLEGE SUPPORTS THE COMMITTEE'S GOAL TO ELIMINATE ABUSIVE VALUATION FREEZES.

The College shares the Committee's concerns about taxpayers who avoid the Federal estate and gift tax laws through the use of abusive valuation freezes, and we support the Committee's objective to eliminate abusive freezes, but the College has been deeply concerned about the complexity and breadth of Section 2036(c). The College feels that section 2036(c) has many flaws, the worst of which it has described in "Section 2036(c)'s Little Chamber of Horrors," which is attached as Appendix A. The College enthusiastically supports the Committee's proposal in the Discussion Draft to repeal Section 2036(c) retroactively.

The College agrees with the Committee that the abusive freeze problem is really a valuation problem, and we believe the Discussion Draft correctly treats abusive freezes as a gift tax valuation matter. We would much prefer to have the Committee adopt the approach set forth in the report of the Joint Section 2036(c) Task Force that is attached as Exhibit A to the testimony of Jere D. McGaffey because we think that proposal will produce a more narrow and simple solution to the problem without any loss of revenue. Nevertheless, we are pleased to have the opportunity to offer our comments on the Discussion Draft.

The College feels the scope of Chapter 14 is broader and more complex than is necessary to solve the valuation problem, and as a result it would unnecessarily intrude in many routine business transactions without thereby solving the

abusive valuation freeze problem. We believe that Chapter 14 can be narrowed and simplified without diminishing its effectiveness in eliminating abusive freezes and without losing any revenue; and that the adoption of our suggestions would reduce the time and cost that taxpayers, their advisors, and Internal Revenue Service personnel will have to spend to understand and administer the law, and would thereby increase compliance with the law.

THE SPECIAL VALUATION RULES IN SECTION 2701 ARE BROADER THAN NECESSARY TO ELIMINATE ABUSIVE VALUATION FREEZES.

1. Chapter 14 should not apply to businesses that are not controlled by the transferor's family. The person who creates an abusive freeze does so because he believes he can cleverly shift a major part of the future appreciation in the business into the common stock that he plans to give away. Believing this, he is not about to share the benefits of such a value shift with nonfamily members who also own common stock. For this reason, virtually all of these transactions occur in businesses that are owned solely by the members of one family. As a result, we feel it is unnecessary to apply the special valuation rules to entities of which a family may own as little as 10 percent. The 10 percent test should be increased to more than 50 percent. If the Committee is concerned about a business that is owned by several families who might act in unison in a recapitalization (a situation we believe is rarely encountered), Chapter 14 should apply only to the members of those families whose combined ownership would exceed 50% of the corporation or partnership.

2. Section 2701 should not apply to equity interests for which a fair market value is readily available. The special valuation rules in Section 2701 prescribe how a preferred interest in a corporation or partnership must be valued in order to determine a value for a nonpreferred equity interest in a corporation or a partnership that is transferred to a member of the family. However, there are several situations in which market values are already available and in these cases using the special valuation rules would be unnecessary and would produce an incorrect and unfair result.

(a) Publicly traded securities. When either the preferred stock or the common stock is publicly-traded, special valuation rules are not needed because market values are readily available and should be used.

(b) Negotiated sales prices. If a person who owns preferred stock decides to sell his common stock to a group of buyers composed of both unrelated persons and family members; and if a substantial portion of the stock is sold to the unrelated persons for a price that is negotiated at arm's length, the special rules in Section 2701 should not apply to the stock sold to a family member for the same price. If the special valuation rules are applied in this case, the seller would be liable for a gift tax on the stock that he sold to his family members at the same arm's-length price he negotiated with the unrelated persons, and in order to avoid a patently unfair gift tax in this situation he must eliminate the family members from the purchasing group and sell only to unrelated persons. Today, this may well mean a sale to an entity that is not owned by U. S. citizens, with the result that the value of the business (and its future growth) will disappear entirely from our

transfer tax system. This adverse tax result is also one of the defects in Section 2036(c), and is described in "Section 2036(c)'s Little Chamber of Horrors" (Appendix A). It should be eliminated.

(c) Sales to ESOPs. The sale or contribution of stock to an employee stock ownership plan (ESOP) is closely regulated and subject to Department of Labor rules that set forth requirements for determining the fair market value of stock acquired by a qualified plan. If shares in the same class of stock are sold to family members as an integral part of an ESOP transaction, the transferor should be permitted to use the value determined for ESOP purposes rather than having to use the special valuation rules.

3. Indebtedness and leases should not be "interests" to which Section 2701 may apply. It is not clear to us how an abusive valuation freeze of an equity interest in a corporation or a partnership can be accomplished by using indebtedness or leases. It is difficult to identify a fact situation in which the existence of debt owed to the transferor or a member of his family, or a lease of property by the transferor to the entity, could cause the value of a corporation's common stock or of a partnership's equity to be diminished for gift tax purposes. If it were possible to diminish nonpreferred equity values through these devices, we believe it would simply increase the value of the transferor's right to receive payments under the indebtedness or the land subject to the lease. If the provision regarding indebtedness is in the Discussion Draft to deal with so-called "self-cancelling installment notes" (SCINs), we recommend that a specific provision be placed in the statute to deal just with this kind of obligation. Including indebtedness and leases in Chapter 14 increases unnecessarily the scope, complexity and intrusiveness of section 2701 because it is so common for one or more owners of a business to lend money or to lease property to the business. This provision will make it much more difficult for the business owner who owns no preferred equity in the entity (and his advisors) to determine when and how the special rules in Section 2701 might apply.

4. An unrelated person should not be considered a member of the transferor's family just because the transferor has made a prior gift to that person. Section 2703(a)(2) provides that if a transferor has made a gift of any kind to someone who is not a member of his family, that person automatically becomes a member of his family for purposes of Chapter 14, apparently forever. Under this rule, if any employee of a corporation who has received stock through a bonus or stock purchase plan is married and receives a wedding gift from the corporation's principal owner, the donee becomes a member of the principal owner's family. The common stock the employee owns would be attributed to the principal owner of the corporation, and any subsequent stock that is awarded to, or purchased by, the employee may become subject to the special valuation rules of Section 2701, thereby exposing the principal owner to all of the valuation and gift tax consequences of Chapter 14. This "adoption by gift" provision makes it necessary for a business owner and his advisors to search the owner's history for the names of all of the persons to whom the owner has ever made a gift, no matter how small and no matter of what kind or nature, in order to determine if and to what extent Chapter 14 may apply to a transfer of stock. We fail to understand how this rule will prevent an abusive valuation freeze. Its usefulness in the general scheme of Chapter 14 is so tenuous that there is no way to justify the extraordinary

complexity it will add to the administration of Chapter 14.

CHAPTER 14 IS MORE COMPLEX AND INTRUSIVE THAN IS NECESSARY TO ACCOMPLISH ITS OBJECTIVE TO ELIMINATE ABUSIVE VALUATION FREEZES.

1. Much of Chapter 14's complexity comes from its scope. The provisions described in the preceding paragraphs (the 10% rule, the failure to permit use of readily available market values, the inclusion of indebtedness and leases, the "adoption by gift" rule), increase the scope of Chapter 14 unnecessarily and thereby increase unnecessarily the complexity of the statute and its intrusion into routine transactions that in no way relate to abusive valuation freezes.

2. Trust transactions should be placed in a section separate from the section that applies to corporations and partnerships. The College understands that the purpose of the trust provisions in Chapter 14 is to deal primarily with grantor retained interest trusts, joint purchases, and private annuities. However, the trust provisions are inserted as exceptions to the rules that apply to corporations and partnerships, which makes it very difficult to sort out the provisions that apply to trusts. We believe it is possible to segregate the provisions that deal with trusts in a separate section and to sharpen the focus of these provisions so that they apply clearly to the perceived abuses at which they are directed. Making these changes would considerably simplify the statute and increase the ability of taxpayers and their advisors to understand and to comply with these rules.

GRANTOR RETAINED INTEREST TRUSTS (GRITs) SHOULD BE GOVERNED BY THE STATUTORY PROVISIONS ENACTED IN 1988.

GRITs have received much attention from the Committee and its staff. After extensive study in 1988, the Committee placed special rules for a so-called "statutory GRIT" in Section 2036(c)(6), and we believe the Committee considered those provisions satisfactory to control the use of GRITs. The College has no information on the number of statutory GRITs that have been adopted since they were specifically authorized, but we submit there is no good policy reason to reverse the decision made in 1988 and now adopt still another rule. Moreover, the Discussion Draft does not indicate what effect the new rules will have on GRITs that have been adopted in reliance on existing law.

NO PROVISION IS NEEDED FOR OPTIONS, BUY-SELL AGREEMENTS AND RIGHTS OF FIRST REFUSAL.

Section 2702 changes significantly the present law that applies to provisions now commonly found in buy-sell agreements. These agreements are not typically undertaken for estate planning purposes, nor are they used to achieve abusive valuation freezes. They are so routinely used by business owners, and the concepts used in them are so commonly understood, that it is not unusual for small corporations and partnerships to enter into buy-sell agreements without even consulting their legal counsel. The usual business purposes of these agreements are to assure a continuation of the business upon the death or withdrawal of one of the owners; to provide a market for the equity interest of the owner who dies or wishes to withdraw by specifying the price and terms on which that interest will be purchased by the person who continues to operate the business; and to prevent the transfer of an interest to a person who might not be acceptable to the continuing owner as a compatible and competent participant in the business. There is now a substantial body of law governing

the use of these agreements that is contained in judicial opinions and in the Internal Revenue Service regulations and rulings. In fact, the estate tax regulations specifically provide that an option or contract price will be disregarded unless the agreement represents a bona fide business arrangement and not a device to pass corporate shares to the natural objects of the taxpayer's bounty for less than an adequate and full consideration. To create a new set of rules to govern these arrangements will completely disrupt and adversely affect the legitimate business arrangements of the vast majority of small businesses in this country. New rules are unnecessary because these agreements are not normally used as abusive valuation freeze devices; if anyone attempts to use them for this purpose, existing law is adequate to prevent the abuse.

THE PROPOSED CHANGES TO THE GIFT TAX STATUTE OF LIMITATIONS ARE UNNECESSARY.

An unnumbered section on page 24 of the Discussion Draft would amend Code Section 6501 to provide for a 6-year statute of limitations instead of a 3-year statute whenever the value of property is determined under Section 2701; and to provide for no statute of limitations if such property is not shown on a return.

1. A 6-year statute of limitations is unnecessary.

The College believes it is not necessary to extend the statute of limitations from 3 years to 6 years, for these reasons:

First, Section 6501(e)(2) now provides for a 6-year statute of limitations if a taxpayer omits gifts from his return whose value exceeds 25 percent of the total amount of gifts stated in the return. This provision will cover any substantial omission of value with respect to a transfer to which Section 2701 applies.

Second, the Internal Revenue Service should be able to identify any Section 2701 transfer and flag it for audit without having to extend the limitations period from 3 years to 6 years.

Third, human nature being what it is, the incentive to proceed with a gift tax audit on a timely basis will be reduced significantly. If there are three years to get the job done, its completion will take three years; if there are six years to get the job done, it will take six years. If more than three years is required in a particular situation, the Service can, and regularly does, request the taxpayer to extend the statute of limitations. It is only in rare situations that the taxpayer refuses to extend the statute, and in these situations the Service simply issues a statutory notice of deficiency based on the facts available to it.

2. An unlimited statute of limitations is also unnecessary.

There are several reasons why the unlimited statute of limitations proposed in the Discussion Draft is unnecessary:

First, Section 6501(a) already provides for an unlimited statute of limitations if no gift tax return is filed, because the limitations period does not begin until the return is filed.

Second, if a taxpayer files a return and deliberately omits a transfer to which Section 2701 applies, Section 6501(c)(1) now provides for an unlimited statute of limitations if the return is false or fraudulent with the intent to evade tax.

Third, if the omission is not due to fraud and if the amount of the omission is greater than 25% of the amount of the reported gifts, the present 6-year statute would apply. This is the same rule that applies to all other types of transfers and apparently has been quite satisfactory.

This narrows the real impact of the proposed change to situations in which a taxpayer unintentionally (and probably unknowingly, because of the statute's breadth and complexity) omits a transfer that is smaller in value than 25% of the amount of the reported gifts. There is no valid policy reason to treat these small transfers in the same manner as a fraudulent return by providing for an unlimited statute of limitations.

3. If the provision for an open statute of limitations is retained, an amended return should start the running of the statute.

The proposed unlimited statute of limitations seems to apply only when a return has been filed and a Section 2701 transfer has been omitted for a reason other than fraud. If that provision is enacted, it should be changed to provide that the limitations period will begin with respect to any such transfer when an amended return is filed that adequately reports the transfer. If this change is not made, the person who files no return at all is in a more favorable position than the person who files a return but, without fraudulent intent, omits a Section 2701 transfer - the person who has filed no return can always start the limitations period running by filing a late return because Section 6501(a) provides that the limitations period begins to run upon the filing of a return even though it is filed after the due date.

4. A forum should be provided to resolve disputes.

Under present law, there is no way for either the taxpayer or the Service to obtain a binding resolution of a valuation dispute if the available unified credit of the taxpayer (and of a married taxpayer's spouse who elects split-gift treatment) exceeds the amount of the gift tax liability proposed by the Service. It is unfair to the taxpayer to be forced to argue a valuation case many years after the initial transfer occurred. A judicial determination of any dispute should be permitted as soon as possible after the time of the gift so the taxpayer will have available to him the lay witnesses he needs as well as expert witnesses who are familiar with the economic considerations and valuation techniques employed at the time of the transaction. Such a judicial determination would enable both the Service and the taxpayer to resolve any question about how much of the taxpayer's unified credit is to be used in situations in which no gift tax is required to be paid.

PROVISIONS THAT SHOULD BE ADDED TO CHAPTER 14.

There are several other provisions that should be added to the Discussion Draft:

1. The Discussion Draft contains a provision that

would repeal all of Section 2207(B) even though only 2207(B)(b) specifically applies to 2036(c). The other parts of 2207(B) apply to 2036(a) and (b), and they set forth what we consider to be an acceptable rule. We suggest that only 2207(B)(b) be repealed.

2. Persons who took corrective action at the end of 1989 in an effort to comply with Notice 89-99 should be permitted to rescind those actions without adverse tax consequences.

3. The Summary of the Discussion Draft states that qualified fixed payments from corporations or partnerships would be valued "by determining the value of the income stream, using appropriate market discount rates." In the case of trusts, the Summary says that QFPs "would be valued (as under current law) according to the appropriate Treasury Tables." The Draft itself does not contain any provision that sets forth these rules, and we believe it should.

4. The Summary also says that employment agreements would not be affected by the QFP rules; the Draft does not say this, and we believe it should.

5. A provision should be added that states:

"Nothing in this Chapter shall be construed to change existing law with respect to the valuation of property for purposes of Chapter 11, 12 or 13 except as expressly provided in this Chapter."

6. A provision should be added to the separate section on trusts that says:

"Nothing contained in this section shall be construed to cause section 2036 to apply to any transfer to which it would not otherwise apply."

TECHNICAL DRAFTING SUGGESTIONS.

The College has prepared a separate description of drafting suggestions that it believes represent a constructive effort to help create a "user friendly" statute that will accomplish the Committee's objective of stopping abusive valuation freezes. These suggestions are in Appendix B.

THE COLLEGE BELIEVES THAT NO REVENUE WILL BE LOST IF ITS RECOMMENDATIONS FOR THE RESTRICTION OF CHAPTER 14'S SCOPE AND COMPLEXITY ARE ADOPTED.

In determining the revenue impact of repealing Section 2036(c), we believe the Committee should regard the revenue gain from Section 2036(c) since December 1987 as a permanent gain (because we believe that abusive valuation freezes have been neutralized since that time), and it should assume that Chapter 14 will continue to produce the same long-term revenue gain that Section 2036(c) would produce if it were not repealed. Chapter 14 will generate near-term gift tax revenue and, in addition, when taxpayers engage in nonabusive

recapitalizations for valid family planning purposes, they will increase the revenue from income taxes on qualified fixed payments that are permitted under Chapter 14. Our recommendations, if adopted, should not cause any change in that revenue picture.

APPENDIX ASECTION 2036(c)'S LITTLE CHAMBER OF HORRORS

The impact of Section 2036(c) falls primarily on people who own small businesses. Much wealthier owners of liquid assets can give their growth stocks to their children and keep their bonds and preferred stocks without any fear of 2036(c); and the owner of several unrelated small businesses can give away those with growth potential and keep the "cash cows" without concern. But the farmers and other small businessmen who operate a single business are the primary targets of an excessively broad estate tax provision that singles them out for unusually harsh treatment.

The worst flaws in Section 2036(c) are illustrated by these examples:

- You sell 50% of the common stock in your corporation to your son and the remaining 50% to his business school classmate, and they take over the full management of your corporation. You retire, but you retain all of the preferred stock. They each pay you the fair market value for the common stock. When you die, your son's common stock is included in your estate in addition to your preferred stock, but none of his classmate's stock is included in your estate because the statute treats sales to family members different from identical sales to non-family members. (There is no way to explain the policy reasons for imposing an estate tax on a person who sells his business to a family member for a fair price but exempting that person from the tax if he sells his business to a stranger for the same fair price.)
- Your son and his classmate transform your sleepy little corporation into a hot property by adding new lines of business and transforming it into a key supplier to the computer industry. The common stock's value rises to ten times what they paid you for it solely because of their new business activities. When you die, your son's stock is included in your estate because you still own the preferred stock. You can subtract from the common stock's value an amount attributable to the cash your son paid you for the stock, but all of the remaining value that his efforts added to the stock is taxed in your estate.
- The value of your son's common stock is so large that the estate tax on that stock exceeds the value of your own assets. Your will says that all estate taxes due as a result of your death must be paid from your estate, and this wipes out all of your assets that your spouse expected to live on. The Internal Revenue Code permits your estate to recover the tax from your son. Your spouse (his mother) doesn't want to do this, but economic necessity forces her to do so, and your son winds up paying an estate tax on value he added to the business even though he's still very much alive and hasn't transferred his stock to anyone else.
- If before you die your son and his classmate decide to sell the company to IBM for ten times its original value, you are stuck with a gift tax on the increase in the value of your son's stock. Not to worry - the statute gives you the right to compel your son to pay you the amount of the gift tax, and this will put him in the happy position of paying a capital gain tax on the increase in value and also a gift tax on the same increase in value even though he kept the sales proceeds and didn't make a gift to anyone. Depending upon the income tax and gift tax brackets that apply, the combined income and gift taxes could represent 75% or more of the increase in value.

* * * *

APPENDIX B

TECHNICAL DRAFTING COMMENTS ON
DISCUSSION DRAFT OF MARCH 22, 1990
RELATING TO ESTATE TAX VALUATION FREEZES

"Interests" and "Rights"

The terms "interest" and "right" are used interchangeably throughout the Draft, which is confusing. The problem affects the following sections:

- Section 2701(a)(2)(A) refers to: "[t]he value of any retained interest which is not a right to receive qualified fixed payments..." This implies that an interest and a right may be the same thing.

- In 2703(b) "interest or right" is used, which suggests someone may own a right without owning an interest.

- Section 2703(c)(2) refers to "an interest in such entity" but not to a right in an entity.

- Section 2703(e)(3) says that any "right" to receive payments from a 10-percent owned entity under any indebtedness or lease shall be "treated" as an interest (suggesting that rights are not interests and are not to be treated as interests without specific statutory authority).

- The definition for a "specially valued retained interest" in 2703(e)(2) refers to an interest (but not a right) that was valued under 2701(a)(2)(A) or (B). Section 2701(a)(2)(A) deals with the valuation of an "interest," and 2701(a)(2)(B) deals with the valuation of the "right" to receive a QFP.

- "Interest" is not defined, but "equity interest" is defined in 2701(a)(3)(B)(ii) to mean "stock or any interest as a partner." (Section 2703(e)(1)(A)(ii) contains a more limited reference, to the "capital or profits interest" in a partnership.)

- "Right" is not defined, but "specially valued fixed payment rights" are defined in 2701(d)(4) as the right to receive qualified fixed payments under a "specially valued retained interest." (We suggest it would be easier to eliminate the reference to a "specially valued retained interest," and simply say that a specially valued fixed payment right is a qualified fixed payment that has been valued under Section 2701(a)(1)(B), thus preserving the idea that the term doesn't apply to a QFP if the transferor elects out of special valuation treatment for that QFP.)

- "Instrument" is also used as a substitute for "interest" in 2701(a)(2)(C): the lead-in language speaks of "the following retained interests," two of which are called "instruments."

In the overall scheme of 2701, it seems clear that an owner of an "interest" in common stock may have several rights, but only one interest in that stock. The same is true of a preferred stockholder, a general partner or a limited partner.

However, 2701(a)(2)(A) says that the value of an "interest" that is not a right to receive QFPs shall be valued at zero. What if a preferred stock owner is entitled to receive \$100 per share on a fixed date in the future (which is a QFP under 2701(b)(1)(A)(i)), and dividends that are not determined at a fixed rate? The preferred stock is an "interest" (it falls within the definition of "equity interest"), but is it valued at zero because it is not a right to receive a QFP; or will the value of the interest be the special QFP value for the right to receive the \$100 plus the zero value for the right to receive dividends that are not QFPs? The answer should be that some "rights" that are part of an "interest" may be valued at zero under 2701(a)(2)(A); some rights that are part of the same interest will be valued under 2701(a)(2)(B) if they are described in that section; those rights that are described in 2701(a)(2)(C) will be valued under pre-Chapter 14 law; and the sum of the values thus determined for all of the "rights" will be the value of the "interest."

The distinction between an interest and a right is also important under 2701(d)(1) and (2), which requires that we revalue particular "rights" rather than the interest itself. However, while 2701(d) deals with the revaluation of "rights," 2701(d)(5) provides that the termination of an "interest" is to be treated as a transfer, leaving open the possible interpretation that the termination of one of several "rights" under a particular interest will not be a transfer unless the entire interest terminates at the same time.

Trust Interests. We understand that Section 2701 is not intended to apply to a beneficiary's assignment of his interest in the income or principal of a trust, and our discussion of this section leads us to believe that section 2701(a)(4) should be modified to refer to the "transfer of an interest in trust" instead of "in a trust." Unfortunately, including a trust in the definition of a 10-percent owned entity, and having Section 2701 apply to transfers in those entities, means that the references in Chapter 14 to transfers in a 10-percent owned entity become references to transfers in a trust; and the problem is compounded by specific references to transfers in a trust such as the one in 2701(a)(4). The provisions in Section 2703(e)(4) (which deals with "a transfer of an income or remainder interest with respect to a specified portion of the property in a trust") can apply both to a transfer of property to the trust and to a transfer by a beneficiary of his interest in the trust. For this reason, and also because there are special provisions for trusts that are scattered throughout sections 2701 and 2703, we submit that all trust provisions should be placed in a separate section. We have tested the possibility of doing this from a drafting point of view and are convinced that it is possible to segregate the trust provisions without damaging any of the Committee's objectives for Chapter 14.

General Drafting Suggestions

We suggest that any reference in the Draft to the transfer, retention or valuation of an "interest" should instead refer to a particular kind of interest. In the case of a corporation or a partnership, the term "equity interest" should be used, and the definition of equity interest in 2701(a)(3)(B)(ii) should be expanded to pick up the language in 2703(e)(1)(A)(ii), so that it would read:

"The term 'equity interest' means stock in a corporation or any interest in the capital or profits of a partnership."

If indebtedness remains in the statute as an "interest" there should be a separate definition for a "debt interest;" and if an interest as a lessor remains in the statute, there should be a separate definition for a "lessor interest." This distinction is important because, if our understanding is correct, debt and lessor interests are significant only in valuing the transferred equity interest and for deemed transfer and valuation-on-death purposes, and 2701(a) is not intended to apply to the transfer of a debt interest or a lessor interest to determine if there is a gift or the amount of the gift.

The Summary of the Discussion Draft states that employment agreements are not to be affected by these rules, but nothing in the Discussion Draft says so. The definition of "equity interest" (and of "debt interest," if there is one) should state that such an interest does not include any contractual right or claim against the entity that arises because the entity employs the transferor or a member of his family. However, any stock acquired as compensation would be treated as an equity interest once it has been reduced to the employee's possession.

If the concept of a lessor interest is not eliminated, the definition should make it clear that a lessor/lessee relationship with the related entity is not a "partnership" and thus an "entity" in which an interest may be transferred.

A lessee's interest in leased property also comes within the definition of a "term interest" as defined in 2703(d)(3), which could cause all leasehold arrangements to be treated as a transfer of an interest in trust. And the interest of a borrower in the borrowed money is also arguably "an interest in property for a term of years," and thus a term interest. The definitions of a debt interest, a lessor interest or a lessee interest should state that these relationships shall not be treated as a partnership or a trust.

Specific Drafting Proposals Related to "Interests" and "Rights"

We suggest that the sections that rely on "interest" or "right" be revised to read as follows:

2701(a)(1)

"(1) IN GENERAL -

(A) If a transferor transfers an equity interest in a 10-percent owned entity to a member of the transferor's family; and

(B) If the transferor (or a member of the transferor's family other than the transferee) retains an [equity interest] [equity, debt or lessor interest] under which the owner of the retained interest possesses a right that has preference over any right under the transferred equity interest,

then, solely for the purposes of determining whether such a transfer is a gift (and the amount of such gift), the value of each retained interest described in subparagraph (B) shall be determined as provided in paragraph (2)."

Comments

(1) The suggested language differentiates between an "interest" and a "right". It reflects the notion that an interest is what the transferor owns and either transfers or retains; but that a "right" is something that attaches to the interest and is normally not transferred or retained separate from the transfer or retention of an interest. The only "right" that is sometimes transferred or retained separate from the transfer or retention of an interest is a voting right (as in the case of revocable or irrevocable proxies, stockholder agreements with respect to voting rights, etc.), but the Discussion Draft provides that voting rights are to be disregarded in determining the value of a retained interest to which they attach.

(2) The bracketed material in subparagraph (A) indicates a decision that must be made about whether the retained interest that is to be specially valued will be confined to an "equity interest" or will include indebtedness or leases as now provided for in the Draft.

(3) Subparagraph (A) speaks in terms of the transfer of an "equity interest" to make it clear that, if a debt interest or a lessor interest remains in the statute, the transfer of the debt interest or the lessor interest is not a transfer that triggers the application of 2701(a).

(4) Subparagraph (B) picks up the concept set forth in 2701(a)(2)(C)(iii), which we regard as an indirect definition of a preferred interest, i.e., any "instrument" ("interest") under which its owner possesses at least one right that has a preference over any right possessed by the owner of the transferred interest.

2701(a)(2)

We suggest that the first part of subparagraph (A) be revised to read:

"The value of any right under a
retained interest...

and that subparagraph (B) on page 2 of the Discussion Draft, lines 22 and 23 (carried over to the top of page 3) be modified as follows:

"For purposes of determining the value of the right to receive qualified fixed payments under any instrument that sets forth the rights under the retained interest, it shall be assumed that ---"

and that subparagraph (C) be modified to read as follows:

(C) Valuation of Certain Other Interests Rights - The value of the following retained interests or rights under such retained interest shall be determined without regard to this section:

(i) Any instrument retained interest of the same class as the transferred interest.

(ii) Voting rights.

(iii) Any interest created by any instrument none of the rights under which have a preference over any rights under the transferred interest.

Comments:

(1) In the Discussion Draft, the caption for 2701(a)(2) is "Valuation of Retained Interests". However 2701(a)(2)(C) refers to "rights" in the caption, "retained interests" in the text, and "any instrument" in (i) and (ii). No definition of these terms tells us if they are equivalent to one another or what the differences are. The approach of the suggested language is that a "right" is possessed by virtue of owning an "interest," and an "instrument" is a document that describes the nature and scope of the right.

(2) Section 2701(a)(2)(C)(iii) is probably unnecessary if the suggested language for 2701(a)(1)(B) is used because the concept in (C)(iii) is incorporated in subparagraph (B). A negative inference embedded in 2701(a)(2)(C)(iii) as it appears in the Discussion Draft is that, if the transferor retains an interest in "any instrument" that has one or more rights that are preferences over any right under the transferred interest, the value of such a retained interest shall be determined with regard to 2701. This can be read as a definition of a retained "interest" that would include debt, leases and any other contractual right of any kind, and is one of the reasons for transferring the concept in (C)(iii) to 2701(a)(1)(B).

(3) The suggested language omits the provision that subparagraph (C) does not apply to a trust because we would like to see all provisions that apply to trusts in a section separate from the one that deals with corporations and partnerships.

2701(a)(3)

We suggest it is not necessary to define "junior equity interest". It is used only once in the substantive provisions of the Draft, in 2701(a)(3)(A), and is defined in 2701(a)(3)(B) only "for the purposes of this paragraph." (However, the term is also used in 2703(f)(1) with no further definition, but that language can be revised.) If the definition is deleted, Section 2701(a)(3)(A) would be changed to say:

"The application of paragraph (1) to any transfer of common stock in a corporation or of a partnership interest that is not preferential shall not result..."

Comments:

(1) All definitions should be grouped together rather than being scattered throughout the Draft (as are the definitions in 2701(a)(3)(B)); if a cross-reference is desirable, place it where needed, e.g., as the Draft does at the end of 2701(a)(4)(B) at the top of page 5.

(2) Compare the language used to describe preferential rights in 2701(a)(3)(B)(i) on page 4 of the Draft to the description of "other rights" in 2701(a)(2)(C)(iii) on page 3. The former provision refers to any partnership interest which is not "preferential," and the latter provision refers to "any instrument none of the rights under which have a preference over any rights under the transferred interest." The language in the second provision should be used either in place of "preferential" or as a definition for "preferential." If short reference terms are desired (and they probably would be useful), use the terms "preferred interest" and "nonpreferred interest."

2701(d)(1)

It seems unlikely that the "right" to a specially valued fixed payment will be transferred separate from the specially valued retained "interest" of which the payment is a part. Section 2701(d)(5) of the Draft reflects the same idea because it provides that the termination of an "interest" (not a right) shall be treated as a transfer. Section 2701(d)(1) should read:

If the transferor transfers any specially valued ~~fixed---payment---rights~~ retained interest, the transferor shall be treated as having made a transfer of property by gift (on the date of such transfer) in an amount equal to the excess (if any) of -

(A) the fair market value of ~~such-rights the~~ retained interest as of the time of the transfer determined with regard to the rules of subsection (a)(2)(B), over

(B) the fair market value of ~~such-rights the~~ retained interest determined without regard to the rules of subsection (a)(2)(b).

Comments:

(1) Similar changes should be made to 2701(d)(2).

(2) We read 2701(d)(1) and (d)(2) to say that upon the transfer of an interest that includes a QFP as one of its rights, or upon death of the transferor, the portion of the interest's value attributable to the QFP shall be the greater of (1) the value at the time of transfer or death under a normal valuation approach, or (2) the value at the time of transfer or death based on the special QFP assumptions (payments will be made as provided in the instrument; payments will be made in perpetuity if no fixed termination date). Section 2701(d)(1) should be rewritten to say this:

If the transferor transfers any specially valued ~~fixed-payment rights retained interest, the value of the transferred interest for purposes of Chapter 12 shall be the greater of:~~

(A) the fair market value of such ~~rights the retained interest~~ as of the time of the transfer determined with regard to the rules of subsection (a)(2)(B), or

(B) the fair market value of such ~~rights the retained interest~~ determined without regard to the rules of subsection (a)(2)(b).

Section 2701(d)(2) should be revised in a similar manner.

(3) We believe it is possible for more than one QFP to exist under a single interest, some of which may have a lower value under normal rules than under the special QFP assumptions, and some of which may have a higher value than under the QFP assumptions. The statute should say that the interest shall be valued by combining the value of all of these rights for the purpose of this section .

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STATEMENT OF ARTHUR S. HOFFMAN, CHAIRMAN, EXECUTIVE COMMITTEE, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY WILLIAM T. DISS, CHAIRMAN, ESTATE AND GIFT TAX COMMITTEE

Mr. HOFFMAN. Mr. Chairman, I am Arthur S. Hoffman, chairman of the executive committee of the tax division of the American Institute of Certified Public Accountants.

Joining me is William T. Diss, who chairs our estate and gift tax committee. The tax division has a membership of 25,000 C.P.A.'s. The AICPA is a national organization representing 296,000 C.P.A.'s.

While we enjoy the company of the members of the bar here today, this is not particularly coordinated testimony.

We believe the discussion draft is an excellent basis for beginning a dialog to accomplish two interrelated goals. One is to preserve the integrity of the Federal estate and gift tax system.

The other is to preserve the viability of family owned and closely held businesses which employs millions of Americans and provides goods and services in communities throughout the United States. I said that the two goals are interrelated. We believe that the two goals should not be in conflict.

But, we believe that section 2036(c) does put preservation of family owned businesses in dire jeopardy. We urge you to adopt a substitute which reconciles the two goals.

We believe that the substitute appearing in the discussion draft can be refined to serve the dual purpose.

Section 2036(c) was passed in 1987 and in response to the problem you heard about today. The IRS was not being informed when freeze type transactions took place. And if they were informed, they had difficulty setting values for gift tax purposes of the interest retained versus the interest surrendered.

The counteraction in the form of 2036(c) was the virtual poisoning of the waters on which closely held businesses depend for their intergenerational businesses. If Congress concludes it is desirable for the American economy to permit businesses to continue generation to generation, even though they happen to have earnings and even though they happen to have achieved financial success, the AICPA believes section 2036(c) must be repealed.

As to the replacement of section 2036(c), we share many of the technical concerns expressed by other speakers about proposed chapter 14. The AICPA will submit our technical observations in the near future. The discussion draft is a major step forward. Unlike section 2036(c), it does not ignore the freeze transactions. It does not penalize the founder and his family by forcing the appreciation on his long past surrendered interest into his taxable estate.

The discussion draft still operates out of the fear that the IRS is incapable of valuing interests which are common to business relationships, so long as family members are on both sides of the transaction.

Accordingly, the discussion draft compensates by adopting a rigid valuation structure which may make well-motivated, common busi-

ness-oriented transactions too expensive for most closely held corporations.

Valuation of the founders retained interest presumably will be based virtually exclusively on the market rate of the fixed cash distributions. This is similar to the standard method of valuing pure debt.

In a case of the typical corporate freeze, the dividend rate on the preferred stock taken by the founder in exchange for his common must be set high.

How high? Presumably as high or higher than the rate on the company's debt. If any lower, the exchange will not be equalized and the transfer will be subject to a gift tax liability. However, dividends, of course, are nondeductible, unlike interest payments.

Consequently, a closely held corporation must earn approximately 50 percent more before Federal income taxes at 34 percent to meet its dividend obligations. If the market rate appropriate to the closely held business is 14 percent, then to cover the dividend it must earn 21 percent, not on the net assets on its books, but rather on its theoretical fair market value. Can a closely held business accept such a future commitment? It happens to be a commitment which bears an uncomfortable resemblance to the burdens in leveraged buyouts financed by junk bonds.

Nevertheless, we consider the discussion draft an approach leading to a solution. The AICPA believes it can be modified so the company can undertake an economically feasible payout commitment without causing the founder to be subject to a prohibitively high gift tax.

Our recommendations: The AICPA is preparing a set of technical observations and what we believe will be constructive recommendations to modify the discussion draft. In addition, we suggest that the following should be considered:

Safe harbor rates for qualified payments so that the market rate applicable to the individual company is not necessarily at issue. Reasonable standards for not making a qualified payment, short of insolvency or bankruptcy. Permitting companies making qualified payments since the sole resemblance debt to adopt S corporation status.

The AICPA believes section 2036(c) should be repealed as soon as possible and the effective date should be December 17, 1987, as described in the discussion draft.

The AICPA also believes the integrity of the transfer tax system should be preserved. Last year this committee adopted civil tax penalty reforms.

It was an excellent bill. It was devised in roundtable discussions with various organizations, the IRS, Treasury, and members and staff of the Oversight Subcommittee.

The discussion draft can be the frame of reference for similar intensive discussions starting immediately after this hearing if you authorize their commencement.

We appreciate the fear of some that immediate repeal of section 2036(c) and a delay would open a window to abusive transactions. We believe the IRS can keep the window closed by prescribing disclosure of the transactions which might have gift tax implications.

However, if you consider disclosure inadequate, then we recommend that with repeal of section 2036(c), Congress prescribe that when a replacement is adopted, it will begin to apply on the date you announce your decision.

In conclusion, Mr. Chairman, we appreciate the opportunity to testify and the AICPA would be pleased to participate in further discussions with whomever you designate concerning a practical replacement for section 2036(c).

Thank you.

[The prepared statement of Mr. Hoffman and a supplemental statement received subsequent to the hearing follow:]

Statement of Arthur S. Hoffman, Chairman of the Federal Taxation Executive
Committee of the American Institute of Certified Public Accountants

INTRODUCTION

Mr. Chairman, I am Arthur S. Hoffman, Chairman of the Executive Committee of the Tax Division of the American Institute of CPAs (AICPA). Joining me is William T. Diss, who chairs our Estate and Gift Tax Committee.

The Tax Division has a membership of 25,000; and the AICPA is the national organization representing 296,000 CPAs.

Mr. Chairman, you have commented that since the provisions of section 2036(c) were enacted, "concern has been expressed about their complexity and breadth." The AICPA shares that concern, and we congratulate you for the release of the "Discussion Draft," and for holding these hearings to begin an "informed discussion," as you phrased it, "about possible modifications to section 2036(c)."

We believe that the modifications proposed are an excellent basis for beginning a dialogue to accomplish two interrelated goals. One is to preserve the integrity of the Federal estate and gift tax system, the other is to preserve the viability of family-owned or closely-held businesses, which employ millions of Americans and provide goods and services in communities throughout the United States.

I said that the two goals are interrelated. We believe that the two goals should not be in conflict. But, we believe that section 2036(c) does put preservation of family-owned businesses in dire jeopardy. And we urge you to adopt a substitute which reconciles the two goals. We believe that the substitute appearing in the "Discussion Draft" can be refined to serve the dual purpose.

You have heard from others that there are many technical concerns both with section 2036(c), and its proposed replacement. The AICPA shares many of those concerns. But, today I want to speak in a very non-technical vein about the two, and make several suggestions.

SECTION 2036(C)

Section 2036(c) was passed in 1987 in response to a problem: the Internal Revenue Service was not being informed when freeze-type transactions took place; and, if they were informed they had difficulty setting values for gift tax purposes of the interest retained versus the interest surrendered. The counter-action, in the form of section 2036(c), was a virtual poisoning of the waters on which closely-held businesses depend for their inter-generational existence.

The passage of section 2036(c) produced a delayed reaction. Only after its passage did tax practitioners come to realize how broadly it could be interpreted, and how vague it is.

To illustrate, tax advisers usually discuss with their clients the economics and tax results of standard business matters: compensation, leases, stock ownership, formation of new businesses, retirement, insurance coverage, and indeed "freezes." However, after tax advisers examined section 2036(c), and discovered a shocking absence of functional limits, conversations with clients went like this:

"I have told you what I do know about the taxation of the (compensation plan, lease, etc.). But now let me tell you what I do not know and what is unknowable: there is a provision called section 2036(c), and I cannot advise you on whether or not you are safe in adopting the plan."

Then the client says:

"When will you know? In a month? In a year?"

The tax adviser responds:

"We may not know until about 3 years after you die, during your estate tax examination."

After the client expresses a few obscenities, he may ask:

"What will be the tax cost, if the IRS decides that this thing called section 2036(c) applies?"

The tax adviser then responds:

"Oh, about 60 percent of the value of the company, as determined by the IRS, when you die."

With that, the client's reaction too often is:

"My kids can't handle a tax payment of 60 percent of the business when I die; why would they want to work here? Let's make plans to sell."

Some say that taking 60 percent of the wealth of a successful business owner is a desirable thing to do in our society and that a "freeze" thwarts this objective. The AICPA takes no position on such questions. However, as tax and business advisers to all types and sizes of businesses, we can tell this Committee that we foresee that the consequence of section 2036(c) is a relentless pattern of sales and liquidations of family-owned businesses.

If Congress does conclude that it is desirable for the American economy to permit business to continue generation-to-generation, even though they have achieved financial success, then the AICPA believes that section 2036(c) must be repealed.

REPLACEMENT OF SECTION 2036(C)

I have said that we share some of the concerns expressed by other speakers about proposed Chapter 14 as it appears in the "Discussion Draft." The AICPA will submit our technical observations in the near future.

The AICPA recommends that Congress consider whether any proposal to replace section 2036(c) serves the two goals I mentioned earlier: preserving the integrity of the Federal estate and gift tax system, while simultaneously permitting successful closely-held businesses, as a practical economic matter, to maintain their existence.

The "Discussion Draft" is a major step forward. Unlike section 2036(c), it does not ignore the "freeze" transaction. It does not penalize the founder and his family by forcing the appreciation on his long-past surrendered interest into his taxable estate. We believe that is a very positive shift in tax policy.

But, the "Discussion Draft" still operates out of the fear that the IRS is incapable of valuing interests which are common to business relationships, so long as family members are on both sides of the transaction. Accordingly, the "Discussion Draft" compensates by adopting a rigid valuation structure which may make well-motivated, common business-oriented transactions too expensive for most closely-held businesses.

The valuation of the founder's retained interest presumably would be based virtually exclusively on the market rate of the fixed cash distributions. This is similar to the standard method of valuing pure debt. So, in the case of the typical corporate "freeze," the dividend rate for his common must be set high. How high? Presumably, as high as the rate on the company's debt. If any lower, the exchange will not be equalized, and the transferor will be subject to a gift tax liability.

However, dividends, of course, are non-deductible, unlike interest payments. Consequently a closely-held corporation must earn approximately 50 percent more, before Federal income taxes (at 34 percent) to meet its dividend obligation. For example, if the market rate appropriate to the closely-held business is 14 percent, then to cover the dividend it must earn 21 percent--not on the net assets on its books, but rather on its theoretical fair market value! Can a closely-held business accept such a future commitment? It happens to be a commitment which bears an uncomfortable resemblance to the burdens in leveraged buyouts financed by "junk" bonds.

We are concerned that the results will be similar; that companies will fail to generate sufficient income to cover their obligations and to grow. In that connection, the company involved in a transaction covered by the "Discussion Draft" must pay dividends until it falls into insolvency or bankruptcy. If it does not pay to that point, the founder will be deemed to have made an annual constructive gift. What commercial lender would finance the working capital needs of a business that had such fixed pay-out obligations?

Nonetheless, we consider the "Discussion Draft" an approach leading to a solution. The AICPA believes that it can be modified so that the company can undertake an economically feasible pay-out commitment without causing the founder to be subject to a prohibitively high gift tax.

RECOMMENDATIONS

The AICPA is preparing a set of technical observations and what we believe will be constructive recommendations to modify the "Discussion Draft." In addition, we suggest that the following should be considered:

- o Safe harbor rates for qualified payments, so that the "market rate" applicable to the individual company is not necessarily at issue.
- o Reasonable standards for not making a qualified payment, short of insolvency or bankruptcy.
- o Permitting companies making qualified payments to adopt S corporation status.

This Committee has two propositions before you, now in the form of the "Discussion Draft." The first, repeal of the section 2036(c); and the second, a replacement prescribing a regimen for valuing what owners receive and surrender.

The AICPA believes strongly that section 2036(c) should be repealed as soon as possible, and the effective date should be December 17, 1987, as prescribed in the "Discussion Draft."

The AICPA also believes, as you have stated, Mr. Chairman, that the integrity of the transfer tax system should be preserved. Last year, this Committee adopted Civil Tax Penalty Reform. It was an excellent bill. It was devised in roundtable discussions with various organizations, the IRS, Treasury and members and staff of the Oversight Subcommittee. The "Discussion Draft" can be the frame of reference for similar intensive discussions starting immediately after this Hearing--if you authorize their commencement.

We believe they can result in a bill which satisfies your concern that there should not be abusive avoidance of transfer taxes, but also does not imperil the survival of closely-held businesses which are a major contributor to the health and diversity of the American economy.

We appreciate the fear of some that immediate repeal of section 2036(c), and a delay while the form of replacement is being debated would open a window to abusive transactions. We believe that the IRS can keep the window closed by prescribing disclosure of the transactions which might have gift tax implications. However, if you consider disclosure inadequate, then we recommend that with repeal of section 2036(c), Congress prescribe that when the replacement is adopted it will begin to apply on the date you announce your decision.

CONCLUSION

Mr. Chairman, we appreciate the opportunity to testify. The AICPA would be pleased to participate in further discussions with whomever you designate concerning a practical replacement for section 2036(c).

SUPPLEMENTAL STATEMENT
OF THE
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TESTIMONY ON SECTION 2036(c)

EXECUTIVE SUMMARY

The American Institute of CPA's (AICPA) Tax Division supports repeal of §2036(c) of the Internal Revenue Code (IRC) and submits comments on and suggested modifications to the proposed Chapter 14 substitute. These comments and modifications deal with both policy and technical aspects of the proposed rules. In addition, while we are not economists and do not address how revenue estimates should be made, as tax practitioners working with income, gift and estate taxes for many clients, we have included some factors which should be considered when revenue estimates are developed for this proposal. Finally, we conclude with a recommendation for a study leading to a more complete legislative solution which both facilitates the intergenerational transfer of operating businesses and farm enterprises and prevents abusive freeze transactions.

§2036(c) REPEAL

In general, §2036(c) captures the value at death in the transferor's estate of an equity interest in an enterprise which was transferred after December 17, 1987 by a post-December 31, 1987 decedent. This capture rule subjects to estate tax the appreciation in the transferred equity interest which accrues between the original date of transfer, to the date of death, or deemed gift.

The deemed gift provision subjects the appreciation in the transferred equity interest to a "gift tax" computed as if the transferor died on the date of the deemed gift transaction. These deemed gift transactions include (1) a gift or sale by the transferor of an interest or interests retained in the original transfer, (2) retransfer by the transferee of the equity interest outside the transferor's family and (3) liquidation of the equity interest by the transferee.

The capture rule of §2036(c)(1) reaches transfers which are irrevocable and complete, apparently based on the proposition that an interest in an enterprise cannot be divided among family members. We believe this capture rule, and especially the deemed gift rule of §2036(c)(4), may pose a legal issue as to the limit of Congressional power.

Assuming no legal issue arises, we believe that IRC §2036(c) operates unfairly where the talent and efforts of the transferee, as well as inflation, have caused the increase in value of the transferred equity interest between the date of original gift or sale to the transferee and the date of the transferor's death or deemed gift transaction. This is especially burdensome where the transferor's estate, or the transferor during his lifetime, has insufficient resources to pay the tax on this appreciation. In these circumstances the transferee must pay estate tax or gift tax on the product of his own talents and efforts.

For these reasons, as well as complexity of the provisions, uncertainties of application, and difficulties in enforcement by the IRS and compliance by taxpayers, we believe that §2036(c) should be repealed retroactively. Transfer taxes on appreciation of property no longer owned are far too onerous a burden for this country's small businesses to bear.

SUGGESTED MODIFICATIONS TO PROPOSED CHAPTER 14

Computation of Special Valuation

Section 2701(a)(2) prescribes "special value" rules for the senior or preferred interest described as a qualified fixed payment (QFP) in a business entity retained when the junior or residual interest is transferred by gift (or sale). A discount factor, presumably a market

discount rate, is used to value the retained interest. The special value computation is not specifically defined in §2701(a)(2)(B). Presumably the par or face value of the retained interest (QFP) is multiplied by a fraction whose numerator is the stated yield and denominator is the test market yield.

In many cases, preferred stock and debt in a closely held business entity are not investment grade. The test market yield or discount factor on such instruments may be very high, perhaps 15-20%, because of the non-predictability of future cash flows, high risk of a small business firm, concerns on management succession, etc. Thus, if the stated yield is 8% and the market yield is 16%, the retained preferred stock will be worth only one-half of its par value. This results in a larger value for the gift of the common stock reportable by the transferor, or a larger price to be paid by the transferee to the transferor, unless a 16% yield is stated. Alternatively if the high required yield is stated, it simply cannot be sustained by the entity, particularly if internally generated capital is required for business operations.

We recommend that the lower of the internal rate of return of the entity, or the applicable Federal rate, be deemed to be the market rate used to compute the special value of the retained preferred interest in the entity. IRS published safe harbor market rates based on the principal industry in which the entity is engaged should also be considered.

Many small business firms operate with lower rates of return than publicly held firms because of family tradition and concerns for the community and employees. These firms should not be valued at high market rates, particularly when these rates increased for risk and quality, are higher than the cash flow rate of return for the firms.

Assuming the market rate of return concept is mandated, the transferor should be permitted to rebut the special value of the retained interest, perhaps with a heavy burden of proof, in order to avoid legal issues. In addition, there should be a tolerance rule or range when the market rate factor is redetermined on examination of the transferor's return, in order to avoid significant unexpected gift tax consequences as a result of judgmental disputes on the market rate. Consideration should also be given to making the entire special value system only a safe harbor that can be elected by the transferor.

Definition of QFP

The arbitrary zero value for a non-QFP interest produces a harsh result. A lease providing percentage rentals or license with percentage royalties based on a percentage of the lessee's or franchisee's revenue could be quite valuable and should be reflected in the value of the entity and the junior equity interest in the entity transferred if such payments are required by a binding contract. Similarly, to ignore a right of first refusal or a lease burdening the interest unreasonably exaggerates the value of the interest transferred.

Other interests that might be retained by the transferor include an employment agreement, a non-installment refund annuity and open account debt (even if interest bearing). None of these provides for fixed payments and may not provide a fixed termination date. Each is a valuable non-QFP interest that should reduce the value of the interest transferred in the entity. An exception to Chapter 14 should be provided for interests whose return is based on objective factors such as underlying cumulative cash flow, financial reporting profits or taxable income.

The proposal permits a QFP election for a noncumulative preferred stock dividend or a fixed payment right limited only by income or cash flow of a partnership. This election may not be available where the profits interest changes upon recovery by the holder of his investment in the partnership. This election therefore is generally unavailable for partnerships engaged in the development and operation of real estate or conduct of natural resource extraction activities.

The ability to elect into QFP status should be significantly expanded by directing the IRS to issue regulations or rulings that would specify other QFP interests and transactions to include trusts. Section 2701(b)(4) should be expanded to permit a QFP election on the transferor's income tax return where the transfer is by a sale rather than a gift transaction. Provision should also be made for a gift, bequest or recasting during the holder's lifetime or at the holder's death of a non-QFP interest such as a percentage rental lease. QFP elections by parties related to the transferor should not be required.

Definition of Interest

Debt and leases are treated as interests in the entity by §2703(e)(3). Interest in an entity is not otherwise defined. The intent of the proposed statute appears to include any right to receive payments from the entity and not merely equity interests in the entity. If so, the broad reach of the proposal will result in many of the same problems for small business firms as those posed by §2036(c).

We recommend that Chapter 14 be confined to the retention of and transfer of equity interests in business entities and division of investment instruments into senior preferred and junior residual rights. Debt, employment agreement, lease, license and property sale interests in the entity can be monitored by IRS enforcement of the §7872 imputed interest, §1272 original issue discount and an expanded §482 arms-length standard for sale, debt, lease and license transactions.

Clarification is needed as to whether general or limited partnership interests can be treated as instruments of the same class for §2701(a)(2)(C) purposes, e.g., if the transferor retains a general partner interest and transfers a limited partner interest or vice versa, similar to retentions and transfers of voting and nonvoting stock. The IRS should be given authority in rulings and regulations to expand the definition of certain other rights which can be excepted from the operation of Chapter 14, such as limited partner payback and oil and gas carried interest arrangements.

Junior Equity Rule

The minimum valuation rule for junior equity under §2701(a)(3) requires that shareholder debt be included in determining the value of the transferor's interest. For example, with a 50-50 shareholder debt-equity ratio, 40% of the transferor's equity ownership must be left "unfrozen." We believe this rule is unfair for debt which satisfies §385 and constitutes an asset includible in the holder's estate. Will debt owed by the entity to third parties and guaranteed by shareholders or partners be considered debt of the transferor for this rule?

The 20% minimum valuation rule for junior equity should also consider other rights such as the non-QFP interests and first refusal options discussed above. In addition, it is unclear whether dividend arrearages in QFP preferred stock would be treated as senior equity for the junior equity minimum value rule. Finally, it should be clear that a QFP does not lose its status as such because the junior equity minimum rule is no longer satisfied due to a decline in overall value of the entity.

Effective Date

Chapter 14 is an entirely new valuation concept and should be applied only prospectively. We believe the effective date of these new valuation rules should be transactions on or after the date of enactment. At a minimum, transactions before the date definitive legislation is introduced should not be affected by these rules.

Constructive Gifts

A constructive "Dickman" gift results when dividends on QFP preferred stock are not paid, even though there may be valid business reasons for not paying the dividend, and the transferor may have no control over dividend declarations. The insolvency test under state

corporation law (inability to pay maturing debts) may prevent payment of the preferred dividend. Under present law a court may find that no gift had occurred in these circumstances. Section 2701(g) unreasonably expands the "Dickman" gift rule.

The deemed gift exception in §2701(c)(2)(B) where the omitted preferred dividend is compounded often will result in a reverse freeze to the transferor, i.e., the QFP preferred stock or senior partner capital interest will increase in value more rapidly than the common stock or regular partner capital transferred. The compounding could even decrease the value of these junior equity interests. This same result could occur with a QFP election for debt of the entity held by the transferor when unpaid interest is compounded.

The §2701(c) and (d) deemed gift and estate tax increase seem to apply even though the total value of the entity has declined below the stated or special value of the QFP, as increased by omitted QFP arrearages. The deemed annual gifts should cease no later than the time of which the QFP plus arrearages equals the total value of the entity minus the 20% junior equity minimum value. The provision should be expanded to compute the value of the QFP at the date of later transfer or death by reference to the total value of the entity reduced at least by the 20% minimum value of the junior equity.

Provision should also be made in the deemed gift or gross estate inclusion provisions of §2701(d) to reduce the deemed gift or estate increase by the consideration paid by the transferee and/or the actual regular gift or estate tax value of the QFP transferred or held upon death of the QFP holder.

Section 2701(c)(3) provides a Federal gift tax refund if the omitted dividend, which resulted in a deemed gift after the lapse of three years, is thereafter paid by the entity to the QFP holder. Provision should also be made for refund of the direct skip gift tax and restoration of the unified credit and the GST (generation skipping transfer) exemption where applicable, both for the transferor and a spouse consenting under §2513 to split report the gift. Adjustments must also be made for actual payments on non-QFP interests which could not be considered in valuing the junior equity interests in the transferor's gift tax return reporting the initial transfer. Treatment upon death of the holder, for missed QFP payments, should be explained.

The exception contained in §2701(d)(3) for the additional estate tax upon death of the QFP holder prevents a basis step-up when the QFP passes to the holder's surviving spouse and qualifies for the §2056 estate tax marital deduction. Treatment of an QFP transfer as a gift in §2701(d)(1) presumably entails a Federal gift tax basis adjustment under §1015(d). However, the gross estate increase in §2701(d)(2) upon death of the QFP holder, does not appear to permit a rebasing of the QFP under §1014. Provision should be made for a basis adjustment under the general marital deduction property basis rules.

Section 2701(d)(5) related to termination of an interest may be interpreted to treat the termination of a grantor retained income trust (GRIT) as a transfer. However, the gift valuation rule of §2701(d)(1) does not appear workable inasmuch as a GRIT interest has no value at the time of termination and deemed transfer.

Section 2701(f) excuses the omission of a dividend by a corporation or a guaranteed payment by a partnership to the QFP holder where the entity is insolvent or subject to a Title 11 case. However insolvency for §2701(f)(2)(A) defines insolvency for §108(d)(2) without regard to debt in fact owed by the entity to the transferor. Local corporate law prevents payment of dividends on preferred stock using a definition of insolvency related to ability by the corporation to pay maturing debts or obligations (as compared to the proposed balance sheet definition of insolvency), including debt to family members and omitted QFP arrearages. Additional circumstances should be provided by statute or regulatory authority to excuse the nonpayment of dividends, and the resulting "in effect" taxable gifts, based on business hardship, or legal constraints such as the local corporation laws.

The requirement to pay dividends may aggravate a business decline. If no dividend is paid, the deemed gift tax imposes a further burden on the family. The insolvency exception is too narrow and should be expanded. Finally, the computation of the gift for an "unexcused" missed QFP payment should reflect the proportionate junior equity interest retained by the transferor.

Certain Options

The rules related to certain options, in particular buy-sell agreements, are especially troublesome. The requirement in §2702(b)(2) that the price formula in a buy-sell agreement be reviewed (renegotiated?), in effect at three-year intervals, poses practical difficulties particularly where non-family members are parties to the agreement. Guidance is needed as to what constitutes a review of a buy-sell agreement price formula under §2702(b)(2)(A).

We oppose the buy-sell agreement governance provisions and recommend they be deleted from the proposal. At a minimum, buy-sell agreements involving non-family members should be excepted from these rules.

Treatment of Trusts

The trust rules should be organized in a separate valuation rule provision. A trust beneficiary should be allowed to elect QFP treatment. In addition, it seems unfair that only a 65-day grace period is allowed for the payment of the annual amount due under a grantor-retained annuity trust (GRAT) or grantor retained unitrust (GRUT), compared to the 3 years grace period to pay the stated preferred stock dividend. Furthermore, coordination with §2036(a) is needed to prevent double counting of the trust property, i.e., inclusion of both the remaining QFP amount under §2033 and corpus under §2036(a), if the transferor dies during the trust term.

Clarification is needed as to whether the §2701(b)(1)(C) life contingency rule applies to a GRIT, both as to whether the QFP may terminate at the grantor's death and whether a reversion in the event of the grantor's death reduces the value of the transferred interest.

Definitions

An ownership attribution rule should be added to §2703(b) to compute the transfer by reference to the interest owned by the transferor in the related corporation, partnership, trust or other entity. The provision treating a donee unrelated to the transferor as a member of the donor's family should be eliminated.

Section 2703(c) mandates treatment of a redemption, capitalization, contribution to capital or other change in the capital structure of the corporation or partnership as a transfer of an interest in the entity except as provided in regulations. "In effect" transfers should be defined by regulations in order to avoid uncertainty as to transfers not described. For example, will a grant by the entity of a stock option be considered the transfer of an interest, i.e., be a change in capital structure for §2703(c)?

Section 2703(d)(2) treats a joint purchase of property (with term and remainder interests) as a transfer by the term interest holder of the remainder interest. The transaction should be treated as the purchase of undivided interests. Will §2703(d)(2) apply to a purchase of property or interest in an entity by parent and child as joint tenants? Will §2703(d)(2) apply to a gift of property or interest in an entity in trust to child for life and remainder to grandchild?

The deemed transfer rule for a joint purchase under §2703(d)(2) should be confined to the purchase of term and remainder interests in specific property and not include a start-up entity or enterprise.

Statute of Limitations

Section 6501(c)(9) tolls the Federal gift tax statute of limitations indefinitely where the transferor considered the transaction to be a sale and therefore did not show the transaction on a gift tax return, i.e., reports the transaction on his income tax return. An indefinite statute of limitations is not good tax policy. Mandated information return reporting of these transactions will promote better tax administration than the penalty of an unlimited period for IRS examination.

The unlimited tolling under §6501(c) of a transaction that was not shown as a gift, applies only to the transfer of the interest in the entity and not to other gifts made for that year. Clarification is needed as to the effect on cumulative taxable gifts on gift tax returns filed for subsequent years and adjusted taxable gifts on the transferor's estate tax return. The Federal gift tax statute of limitations should close when the estate tax statute of limitations close.

Other Matters

Control of the entity is presumed for a 10% owner transferor. The application of Chapter 14 should be confined to a transferor who actually controls the entity, e.g., owns more than 50% of the entity directly and indirectly.

Because Chapter 14 is such a novel statutory valuation concept, other areas of the Internal Revenue Code are affected by the concepts presented therein. We recommend that the legislative history explain that Congress does not intend that QFP senior equity interests be considered debt for §385 purposes. In general, S Corporations are only allowed to issue one class of stock. With the creation of QFPs as a specific interest with preferred valuation status for gift tax purposes, we believe that §1361 should be amended to permit an S Corporation to issue a QFP without violation of its S Corporation status.

STUDY PROPOSAL

A collegial effort involving the Treasury, IRS, Congressional staff, professional organizations and business groups should study the transfer tax system (1) to facilitate the intergenerational transfer of interests in operating business and farm entities, and (2) to prevent abusive freeze transactions. The project would resemble the group efforts that resulted in the 1980 Installment Sale Revision Act, the 1982 Subchapter S Revision Act and the 1989 Improved Penalty Administration Compliance Tax Act (subtitle G of the 1989 Revenue Reconciliation Act). We believe the product of this study will command general respect by the taxpaying public and their professional advisers, thereby strengthening the transfer tax system and aiding IRS enforcement efforts.

Measures to encourage lifetime transfers of business interests that should be considered include, but are not limited to the following:

1. A safe harbor freeze when the retained interest is preferred stock with a stated cumulative dividend yield at least equal to the after Federal income tax (income tax effected) long-term AFR (applicable federal rate). The income tax effect should reflect both Federal and state levies. For example, if the long-term AFR is 10% and the combined marginal Federal, state and local income tax rates are 40%, the safe harbor preferred yield would be 6%.
2. A safe harbor preferred freeze, using the internal rate of return or the §483 intra-family real estate sale interest rate, as the required return on the retained equity interest in the entity or enterprise.

3. A 14-year period for the payment of interest and gift tax on a defined major gift involving a intergenerational shift in ownership of an operating business or farm. At death, these payments would be liabilities of the estate.
4. A federal taxable gift election by a transferor for his interest in an entity or equity, with payment of the gift tax deferred until the transferor's death. These payments would be liabilities of the estate.
5. An elective federal gift and estate tax value for transfers of common or residual equity interests in an operating business or farm, based on a market rate discount of the forecast income stream of the interest, i.e., use the Chapter 14 methodology to value the interest transferred.

REVENUE ESTIMATES

A substantial part of the revenue loss from transfer taxes in prior years relates to trusts, split purchases of investment instruments and use of the holding corporation or partnership structure to hold investment instruments. The component of the revenue loss from investment instrument transactions will become more significant in future years if there is no remedial legislation.

It is doubtful that the classic transfers of residual equity interests in operating businesses or farms in an intergenerational transactions resulted in significant net revenue losses. Unlike an investment instrument, the revenue loss from an estate freeze transaction for an operating farm or business may or may not occur, depending upon operating results of the enterprise. Freeze transactions involving investment, particularly debt, instruments always result in revenue losses.

The potential revenue loss from repeal of §2036(c) may be already substantially diminished as to operating business and farm enterprises. The extensive conversions from C corporations to S corporation status in 1986 removed the converting corporations from the classic preferred stock recapitalization freeze system. Integration of corporation and shareholder taxation may involve an enlargement of S corporations with a similar effect.

A debt freeze can be accomplished in a Subchapter S regime but the debt issue entails a Federal income tax toll charge upon the exchange of the equity interest for the debt interest in the enterprise. Issuance of the debt may not be an "exchange" transaction, i.e., may be a dividend equivalent so that the entire amount of the debt sourced on earnings and profits, is subject to income taxes and not merely the excess of the value of the debt over the adjusted basis of the stock surrendered by the transferor.

There is a revenue gain when §2036(c) induces the family to sell or liquidate an operating business or farm rather than transferring the enterprise to the next generation. This income tax gain may be partly offset by lower estate values from elimination of the family farm or business enterprise. Further revenue losses may result when the family enterprise is acquired by a larger concern, with loss of income tax revenues from terminated employees, heavy interest charges incurred by the acquiring company and special charges for shutdown of business activities.

There may have been modest income and gift tax revenue gains from transactions undertaken during the correction period provided in TAMRA (Technical and Miscellaneous Revenue Act of 1988) §3031(h)(4), to recast retained interests into the statutory safe harbors of §2036(c)(7) or in some cases to unwind freeze transactions. However, we believe these correction transactions may have been infrequent because of a public perception that §2036(c) was improvident legislation, which Congress was likely to reconsider.

The unnatural requirements of the TAMRA startup loan safe harbor that the transferor (lender) not participate in the enterprise and not transfer business opportunities to the

enterprise and that the transferee be an active participant in the enterprise has discouraged start up firms and decreased income tax revenues. In addition the qualified debt safe harbor enacted in TAMRA may have encouraged shifts from equity to debt interests in enterprises, reducing income tax revenue through interest expense deductions.

Federal gift tax revenue will be enhanced, if Chapter 14 is enacted, by permitting freeze transactions by gift, as well as the "in effect" or Dickman gifts for missed QFP payments. Federal income tax revenue will be enhanced by permitting freeze transactions by sale and by the payment of non-deductible preferred dividends. Estate tax revenues will be enhanced from the elective compounding of missed QFP payments in valuing the preferred equity interest in the entity upon death of the transferor.

The proponents of changes in the transfer tax system give insufficient effect to the long-range revenue gains from the 1976 Tax Reform Act. These proponents point to the decrease in revenues after 1977, which reflected the substantial gift tax payments made on 1976 returns reporting gifts made by donors in anticipation of the 1976 Act adjusted taxable gift provisions. Transfer tax revenue since 1977 has also been reduced with the unlimited marital deduction, the escalating unified credit equivalent exemptions and higher annual exclusions, including the medical and tuition exclusions.

In future years all of these revenue loss factors will be more than offset by gains from taxation at death of adjusted taxable gifts made after 1976, the pyramiding of property in the estates of surviving spouses, the effect of inflation and accumulated income between the dates of death of the first spouse and of the surviving spouse, the high Federal estate and gift tax brackets, the increase in individual wealth from lower Federal income taxes, inflation and a relatively strong economy and overall transfer tax rates twice the income tax rates.

* * * * *

In summary, §2036(c) should be retroactively repealed. Significant modifications should be made to the proposed Chapter 14 so that its provisions will be workable. Consideration should be given to enactment of Chapter 14 merely as a safe harbor elective by the taxpayer, and a study should be instituted of statutory revisions to facilitate lifetime transfers of interests in family owned businesses and farms preventing abusive estate freezes.

Chairman ROSTENKOWSKI. Mr. Archer

Mr. ARCHER. I apologize for not being present. As was your case, I was in a meeting with the President at the White House.

I want to tell the witnesses I regrettably could not be here at that time. If I had been here, I would have made the following statement, which, Mr. Chairman, I would like to be inserted, if appropriate, at the beginning of the proceedings.

[The statement is at the beginning of the hearing.]

Chairman ROSTENKOWSKI. Mr. Wallace, I noted in your testimony you submitted your proposal to Treasury and the Joint Committee on Taxation.

Some of the staff on the Ways and Means Committee would like to see your proposal.

Mr. WALLACE. We will include them as well.

[The following was subsequently received:]

May 25, 1990

BY MESSENGER

Robert J. Leonard, Esq.
Chief Counsel
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

We are enclosing ten copies of the supplementary written comments with respect to the Discussion Draft of Chapter 14. The written testimony of John A. Wallace, Esq., the Division Director of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association, filed on behalf of the American Bar Association ("ABA") was submitted to the Ways and Means Committee for the April 24 hearings. We stated in that testimony that we would be filing additional technical comments.

The comments that follow should be read in conjunction with John A. Wallace's written testimony, as well as with the written testimony of Jere D. McGaffey, Esq., the Chair Elect of the Section of Taxation of the ABA, filed on behalf of the ABA and the written testimony of E. James Gamble, Esq., filed on behalf of the American College of Trust and Estate Counsel. The three groups compose a Joint Task Force which was formed in 1988 to develop an alternative to Section 2036(c). All three groups prepared their testimony in concert and divided the topics among the groups.

Sincerely,

Lloyd Leva Plaine

Lloyd Leva Plaine, Esq.
John J. Lombard, Jr., Esq.
John A. Wallace, Esq.
Pam H. Schneider, Esq.
Frederick R. Keydel, Esq.

Enclosure

May 25, 1990

Supplementary Technical Comments
With Respect to the Discussion Draft of
Chapter 14 on Behalf of the
Real Property, Probate & Trust Law Section
of the American Bar Association

The written testimony of John A. Wallace, Esq., the Division Director of the Probate and Trust Division of the Real Property, Probate and Trust Law Section of the American Bar Association filed on behalf of the American Bar Association ("ABA"), with respect to the Discussion Draft of Chapter 14 was submitted to the Ways and Means Committee for the April 24 hearings. We stated in that testimony that we would be filing additional technical comments.

The comments that follow should be read in conjunction with John A. Wallace's written testimony, as well as with the written testimony of Jere D. McGaffey, Esq., the Chair Elect of the Section of Taxation of the ABA, filed on behalf of the ABA and the written testimony of E. James Gamble, Esq., filed on behalf of the American College of Trust and Estate Counsel. The three groups compose a Joint Task Force which was formed in 1988 to develop an alternative to Section 2036(c). All three groups prepared their testimony in concert, and in order not to be redundant, we divided the topics among the groups. Therefore, it is necessary to read all three written testimonies to see the full scope of our jointly submitted substantive and technical comments.

Our additional technical comments and questions follow. We realize that some of these issues might not be raised under the Discussion Draft of Chapter 14 as the draftsmen view it. In such cases, because the answers are at best unclear, it would be helpful for the statute, or, where appropriate at least the legislative history, to provide the appropriate clarification or reassurance.

I. Technical Comments Applying Mainly to Trusts

1. We believe the trust rules should be moved out of Chapter 14 as they unduly complicate the Chapter. They should be dealt with separately. Carefully drafted separate rules dealing just with grantor retained income trusts and joint purchases could meet the perceived problems dealt with by the Discussion Draft.

2. The exception contained in §2701(a)(4)(A) of the Discussion Draft should explicitly exempt a gift in the form of a direct transfer made from a revocable trust.

3. How does the Discussion Draft treat the inter vivos exercise by a trust beneficiary of a special power of appointment with respect to part or all of the assets of a totally discretionary trust? Would the exercise be treated as a gift of the entire trust entity?

4. In general, how are exercises of distribution powers with respect to a trust treated for gift and gift valuation purposes under Chapter 14? Is the exercise of an inter vivos power of appointment under a trust agreement, or the

participation by a trustee in discretionary trust distributions, subject to Chapter 14? Do trust distributions need to be QFP payments? If trust distributions need to be QFP payments, and the trust distributions are not QFP payments, has a deemed gift been made of the remaining trust properties? If so, who is the transferee of that gift? Likewise, who is the transferor of that gift?

5. How does Chapter 14 apply, if at all, to a transfer to a trust where the grantor reserves the right to determine who gets the income for each of ten years with remainder to child? Of how much has the grantor made a gift at the outset, and each year?

6. Chapter 14 (§2701(b)(2)(D) - the "if" clause) seemingly would provide that, if the donor established a trust, with 10 years income to child and reversion to donor, the entire amount would be considered a gift. It is hard to conceive of situations in which much tax advantage can be obtained by a taxpayer by such an arrangement. If the clause is retained, the transferor should be able to elect in to being a QFP.

7. What is valued under §2701(d) on the date a GRAT ends? Zero and zero, or the value (computed both ways) the retained annuity would have had under §2701(a)(2)(B) if it had not yet ended? To what does §2701(d)(5) apply at the date a GRAT ends?

8. Because a joint purchase is treated under §2703(d)(2) as though the person buying the term interest

acquired the whole and then transferred to the joint purchasers the remainder interest purchased by the other joint purchasers, will a joint purchase thus necessarily be included in the estate of the term interest purchaser under §2036(a)? We do not believe that it should be included in §2036(a) because of the gift tax treatment under Chapter 14. For example, assume a parent who under the tables would have a life estate valued at \$40,000 (in a \$100,000 asset) and the child's remainder interest would be valued at \$60,000. If the parent paid the \$40,000 and the child paid the \$60,000, the statute seems to treat that as a gift of \$40,000 by the parent to the child -- the \$100,00 value of the property less the \$60,000 consideration. However, the joint purchase property should not be in the transferor's estate under §2036(a).

9. Is an estate an entity for purposes of §2703(b)?

II. Technical Comments Applying Mainly to Corporations and Partnerships

1. Are proportionality adjustments made? Assume parent owns 100% of the common stock and none of the preferred stock (all of which is cumulative). Parent's family (but not his son) owns all the cumulative preferred, all of which meets the definition of a right to receive qualified fixed payments ("QFP"). Parent gives 15% of the common stock to his son. What is the property that is counted in §2701(a)(1) as the value of any interest in such entity retained by parent or parent's family members who consent (other than the son)? Does the statute look at 15% of the preferred stock or all of the preferred stock? If

a dividend was later not paid on the preferred, then how much would the deemed gift be?

2. Are routine limited partnerships where all of the allocations are pro rata, exempted from coverage under Chapter 14? The draft statute provides that voting rights have value and that the value of retained interests shall be determined without regard to §2701 in the case of transferred interests which are identical to retained interests except for voting rights. (§2701(a)(2)(C)(ii)). In addition to differences in management rights, limited partners are generally not jointly and severally liable for partnership debts, which is not the case for a general partnership interest. Is this attribute (which is a substantive economic difference) enough to bring all limited partnerships under the coverage of Chapter 14?

3. How is the participation element in participating preferred treated under §2701(b)? For example, how would preferred stock with a cumulative preferred dividend of 5% and then a right to 50% of the profits after a certain point be treated? It appears that the participation would be assigned a zero value and that one could not elect under §2701(b)(4) to have the participation right be treated as QFP.

4. The definition of QFP does not have an exact partnership analogue to cumulative preferred. Cumulative preferred in a partnership does not normally have a definite payment date, but if not paid cumulates. Thus, §2701(b)(1)(A)(i)

should have as an alternative to payment, cumulating, at least annually, if not paid.

5. To what is §2701(b)(1)(C) aimed? It should be clarified to make it clear it does not apply to employment agreements or deferred compensation agreements.

6. Why are leases and debt included as an interest in an entity under §2703(e)(3)? Neither a lease or debt really enter into the value of the common stock or the partnership interest.

III. Gift And Generation-Skipping Transfer Tax Issues

1. The taxable gift adjustment of §2701(c)(3) does not appear to work in a variety of situations.

a. When the retained interest is held by a family member or the spouse of the transferor, the adjustment of §2701(c)(3) appears to result in the wrong party having the adjusted taxable gift. For example, assume parent and child own 100% of a corporation with parent owning 100 shares of common stock and child owning 100 shares of preferred stock which is not a QFP. Further assume parent gives the common stock to his grandchild. It appears that there would be a gift tax and a generation-skipping transfer tax on the full value of the corporation. A later gift of the preferred stock to the grandchild would not cause additional gift or GST tax. However, parent's adjusted taxable gifts would be too high and the child's too low. Furthermore, as is discussed below, no GST tax should

have been paid on the later gift of preferred and yet no refund of the earlier GST tax is available.

b. Where taxable gifts are made after a deemed gift but before payment of QFP arrearages is made, there appears to be no adjustment for the higher tax paid on the intervening taxable gift by reason of the inclusion of the deemed gift as an adjusted taxable gift of the transferor. Section 2701(c)(3)(B) relates to transfers "during the calendar year in which such portion is paid or any subsequent year" and does not say how to deal with gifts occurring between the date of the original transfer and the date such portion is paid.

c. Section 2701(c)(3) does not appear to work where a QFP is paid to an heir of the person who was deemed to have made a gift. Who is entitled to the refund?

2. The statute is not coordinated with the GST tax. The necessary credits, refunds, et cetera are not available with respect to the GST tax. The identity of the transferee will not always be clear even though for purposes of the GST tax, it is necessary to identify the transferee. At a minimum §§2701(c)(3) and (e)(2) must be modified.

a. Section 2701(c)(3) should also cover generation-skipping transfer tax as well as a reinstatement of any GST exemption allocated to such a transfer. See example at Comment 1-a above.

b. If one gives non-QFP preferred stock to a child and common stock to the grandchild, would the gift and,

therefore, the generation-skipping transfer be the value of the whole company? If so, although at a later transfer by the child of that preferred stock, there would be an adjustment in the gift tax, and there would be no comparable restoration of the generation-skipping transfer tax (or GST exemption) because a transfer from the child of the preferred to the grandchild is not a generation-skipping event. The flip side of this problem is where the grandparent gives common stock to the child while keeping non-QFP preferred. In such a case, the transfer to the child will be considered to be the value of the whole company. This is a larger gift than if Chapter 14 was not applicable. If the grandparent later transfers the non-QFP preferred to the grandchild, it will have a very low value and, therefore, will lower the generation-skipping transfer tax that would otherwise be payable if the Chapter 14 was not applicable.

c. If the parent keeps good QFP preferred and gives the common stock to the child but then no dividends are paid, there will be deemed gifts to the child. If the parent later transfers the preferred stock to the grandchild, then because of the operation of §2701(c)(5), the value of the preferred is reduced. Therefore, when the grandparent transfers that preferred to the grandchild, there will be little, if any, generation-skipping transfer tax.

d. What happens if the parent gives property to a trust where the child has a life estate and the grandchild has the remainder interest? Is the gift treated under §2701 as

though all the value went to the grandchild, and therefore, there is an immediate direct skip of the entire property value? Where the parent has no more interest in the entity (in this case, the trust) after the transfer, other than by family attribution, does §2701 apply? Is the child's life estate treated as retained by the parent? If the parent transferred it all and paid a gift tax on it all, why should it be caught as a GST direct skip? It would not have been caught in §2036(c).

3. What happens if parent gives all of the preferred to child on day one and then gives the common stock to another family member on day two? As written, it appears that parent would be treated as having made a gift of the whole value of the company on day two even though parent already was treated as having made a gift on the day one transfer of the value of the preferred. There appears to be no refund of the day one gift tax (or use of unified credit) in this situation even though after day two there has been double taxation of the value of the preferred.

4. There should be no deemed gift if the family member no longer owns the common stock.

5. Section 2701(c)(5) attempts to equalize or avoid the double tax associated with deemed gifts for delinquent QFPs. However, the "double tax" or lack of equalization appears possible in many common situations. For example:

a. There does not seem to be coordination under the income in respect of a decedent provisions. Should a missed

QFP qualify as "deemed" income with respect to a decedent? If the QFPs are later paid, should not the related income tax liability be taxable only after a deduction for the "deemed" estate tax is deducted?

b. Suppose a transferor sells the missed QFP instrument to an unrelated third party before he dies and receives cash consideration that takes into account the high probability that the missed QFPs will eventually be paid. The statute does not offer relief from §2033's taxation of that cash if the transferor dies after that cash sale has been transacted. The result under these facts is double taxation.

6. Section 2701(e) attempts to avoid a double tax by permitting a reduction for purposes of subsequent estate taxation of non-QFP interest. However, complete relief is not attained. For example, if a non-QFP interest in an entity is sold, and if that cash is retained in a transferor's estate, there is no relief under §2033 for the estate taxes associated with the cash received for that non-QFP interest.

7. A double tax is also associated with any returns (e.g., redemption or participation payments, principal amortization payments, and so on) that are paid on non-QFP interests. No gift tax credit is provided for returns on non-QFPs that are actually paid. For instance, suppose a parent transfers his stock interest in a corporation but retains a non-QFP lease associated with one of the buildings of that corporation. To the extent lease payments are made, there will be no gift tax credit

for that cash which will be in the parent's estate. At the parent's later death the lease is decreased by the increased common stock gift value. However, no reduction is allowed with respect to the cash received. Therefore, under this fact situation the Chapter 14-scheme effectively results in a double tax.

8. Several questions and problems exist under §2701(d), the intent of which is to value subsequent transfers of QFP interest consistent with the QFP rules:

a. For purposes of §2701(d)(1), is a transfer to a revocable trust treated as a gift?

b. The calculation under §2701(d) seems to ignore any consideration received (on a lifetime or at death transfer) that exceeds the fair market value of the rights determined without regard to QFP rules.

c. What is valued under §2701(d)(1) and (d)(2)? Is it the value of the specially valued fixed payment rights at the time of the subsequent transfer?

d. In determining under §2701(d) the amount to be treated as a gift or included in the estate upon a later transfer or upon death, doesn't there have to be some reference to how much common was originally transferred? Suppose the father creates a preferred stock interest, transfers 40% of the common to his son and retains 60%, which, together with the preferred, he holds upon his death? Or suppose that, when the preferred interest is created (by an exchange of all of his

common for the preferred) he owns only 51% of the common, having given the rest of the common away before creating the preferred interest? What happens in this case when he dies holding just the preferred interest?

e. It is unclear how the spousal rules of §2701(d)(3) will work when the surviving spouse is not a U.S. citizen. The rules do not seem to fit with the qualified domestic trust rules of §2056A under which the tax at the death of the surviving spouse is treated as being the tax of the first spouse to die.

IV. Comments Relating to Family Member Retained Interests

1. The family consent rules of §2701(b)(3)(B) and §2701(c) are very complex. Further, the placement of §2701(b)(3)(B) is confusing. The consent to special treatment should not be under a title called "Waiver of Special Treatment." Moreover, if a family member consents to the application of the rules, it exposes to potential further transfer tax preferred interests that already belong to the family member and presumably have already been taxed in some fashion or earned by that person.

2. The "dueling siblings" situation needs to be dealt with. For example, assume that parent and daughter (who is not active in business) own preferred; parent gives common to son and daughter consents under §2701(b)(3)(B). Son causes corporation to pass by a dividend. Is daughter deemed to have made a gift to son? If so, this is very unfair. The solution may be to

eliminate from §2701 preferred stock owned by any person in the same generation as the common stock owner.

3. Shouldn't the need for the consent of a non-transferor family member under §2701(b)(3)(B) be treated as waived if such individual is incapacitated? A guardian ad litem would never be able to approve having the incapacitated family member consent because there are only negative implications for the family member. On the other hand, the problem with a deemed or automatic consent is that it might hurt the incapacitated family member through later deemed gifts or additional gift or estate tax. One answer might be to have any later deemed gift be considered to be made by the original transferor rather than by the family member.

V. Miscellaneous Comments

1. QFP Elections

a. The concept of electing QFP treatment set forth in §2701(b)(4) of the Discussion Draft could be broadened to include income trusts, partnerships with other contingencies and joint purchases with other income-producing assets. Deemed gifts would then occur where the table rate applicable to the elected QFP is not met. However, any such provision should be coupled with a refund (and unified credit adjustment) where the table rate is exceeded. Similarly, refunds (and unified credit adjustments) should be available with respect to interests valued at zero where payments are in fact made or interests transferred. Section 2701(e) appears to do this to a limited extent.

b. If the transferor elects under §2701(b)(3)(A) to have "payments" not treated as QFPs, when he later makes a transfer of the right to those payments, he should be able to treat them as being worth zero. With respect to non-QFPs which are treated as being zero by §2701(a), a later adjustment in value of §2701(e) is available. If the transferor elects under §2701(b)(3)(A), it is unclear whether §2701(e) applies.

2. Definition of Family Member

a. Under what circumstances does an individual become a family member under §2703(a)(2) by reason of a gift? It should be limited to a gift of an interest in an entity subject to Chapter 14; otherwise, unrelated business partners who give each other birthday gifts could be subject to Chapter 14.

b. Once a non-family member becomes a family member under §2703(a)(2), is he a family member solely for the purpose of the transfer to that person, or does that person become a family member for purposes of all other transfers made by the transferor at any time after the transferor makes him a family member? Similarly, is he a family member for purposes of determining whether an entity has the requisite family ownership? Presumably, he should just be a family member for the transfer.

c. As presently written, it appears that a charitable donee would be treated as a family member under §2703(a)(2). It should be made explicit that a charity cannot become a family member.

d. How do the indirect ownership rules of §2703(b) operate? Do they operate pro rata, as we believe they should? How do they operate for spray and discretionary trusts? We do not favor the treatment of a spray or discretionary trust in IRS Notice 89-99 in which a permissible distributee beneficiary was treated as though the discretion would be exercised to the maximum extent in that beneficiary's favor -- thereby attributing the whole trust to each discretionary distributee beneficiary.

3. Tax Liability. The ability to pay the transfer tax under Chapter 14 is endangered by §2701(c)(3)(B). For example, assume that the major asset of a transferor's estate is his interest in a closely held corporation (he is the founder's son). He transfers all of his common stock in that corporation (which represents 15% of the common stock of that corporation) to his daughter. He retains a compensation arrangement which is subject to the gross sales of the corporation. The preferred owners of the corporation (who are family members and have 55% of the common stock ownership) refuse to elect into the system. As a consequence, the transferor (the son) is deemed to own 70% of the equity interest of the corporation. Neither the transferor, nor the transferee, have the ability to pay the transfer taxes associated with that transaction. Who pays the tax? It appears possible for a transferee, under this system, to receive a gift, for which the transferee will be liable, which is

not equal to the value of the assets that the transferee received in the gift.

4. Basis Adjustment. Why is there no technical amendment to §1014 the way there is a technical amendment to §1015? Without one, would basis be adjusted (up or down) based on Chapter 14's effect on value?

Chairman ROSTENKOWSKI. Thank you, gentlemen and ladies for joining us this morning. We look forward to receiving your testimony.

Mr. Carlson, you be the leadoff witness.

You all understand what the rules are. We would like, if your statement is longer than 5 minutes, to have it summarized.

STATEMENT OF DONALD W. CARLSON, CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, CARLSON SYSTEMS, INC., OMAHA, NE

Mr. CARLSON. My name is Donald W. Carlson. I am president of Carlson Systems, a family-owned business. We are headquartered in Omaha, NE, and operate 33 warehouse and service centers in major cities west of the Mississippi.

I am also chairman of the board of the National Association of Wholesaler-Distributors (NAW) and it is in that capacity that I appear today.

NAW commends you, Mr. Chairman, and the entire committee for holding this hearing and for the time and interest you have given to the very critical issue of estate freezes. I would also like to commend Mr. Archer for his very early efforts to resolve the enormous problems which have been created by section 2036(c).

Mr. Chairman, last fall you visited with NAW's board of directors and acknowledged at that time that a problem existed with this section of the code and indicated that you intended to work with us and others to resolve this difficult issue.

As always, you were true to your word and I would like to express my personal appreciation for your efforts. We look forward to working with you and Mr. Archer, and the other members of the committee, along with the committee staff, to reach a resolution that will be mutually acceptable.

NAW is a federation of 116 national wholesale distribution trade associations, 57 State and regional trade associations and 2,000 individual wholesale distribution firms. All told, NAW represents approximately 40,000 companies with 150,000 places of business.

The wholesale-distribution industry is typified by small, closely held companies. Well over 90 percent of wholesale-distribution firms are privately held. The average size firm represented by NAW has approximately \$5 million in sales and employs 30 individuals.

The distribution industry experienced a rapid growth in business starts just after World War II. The entrepreneurs who started these companies or took over the reins of family-run businesses are now at retirement age. For most of them, passing on the family business to future generations has been a lifelong goal. Unfortunately, however, section 2036(c) is a profoundly significant barrier to keeping a business in the family.

Last month, this committee issued a discussion draft which would indeed repeal current law—which delights all of us—and replace it with new statutory language. We commend the committee for its action and we are committed to a cooperative effort to produce an acceptable replacement statute.

NAW believes the proposed draft is an extremely positive first step in this process. We believe modifications are necessary, however, and my written statement which I will submit for the hearing record elaborates on our concerns with the discussion draft.

What I would like to do is to give you some personal thoughts from the perspective of a businessman from Omaha.

At the heart of the controversy over estate freezes are the rules by which individual assets of a business, individual rights of a stockholder to receive future income from the business, and the rights to future appreciation of the business are valued.

Valuations for publicly held companies are relatively easy to calculate because the future income of a publicly held company is generally not dependent on any one business, fashion, trend, geographic area, or person. And the value of their stock is set in a public market and can be easily found in the newspaper.

For closely held businesses, however, valuations cannot be made on a purely mechanical basis. Closely held businesses are like fingerprints, they are all different.

Let me make a few points about just one of them—our company. Our company is a third generation enterprise which started in 1947 and the third generation is actively at work in it. My brother, my nephews, my son-in-law, my son and I all work in the business. The basic imperative in operating a privately held business like ours is that in order to survive, our company must grow.

Companies in my industry, like most others, which do not grow do not stay in business over the long term.

Growth requires continuous reinvestment of profits and reliable sources of capital. Unlike publicly traded corporations, most privately held companies do not have ready access to long-term financing. We have ongoing commitments to lenders in order to keep our company viable.

Despite what may be perceived by some, the typical closely-held business person is not a "fat cat."

Substantial profits do not necessarily translate into excess cash. A company may be highly profitable, but lack sufficient cash for daily operations. On the other hand, a company with excess cash could be in that position because it is selling off assets and inventory and may be in a negative profit mode.

That being said, one concern I have regarding the discussion draft is its requirement to pay a regular dividend over an indeterminate amount of time. Cash required for business operations would have to be diverted to pay dividends.

Therefore, loan agreements, supplier agreements and asset needs of the business could potentially be jeopardized.

Another concern with the discussion draft is the dividend rate used to value the preferred stock. In our case, it would be impossible to look into a crystal ball and predict our future earnings and ability to pay a specific dividend indefinitely.

A third concern with the draft is its failure to distinguish between abusive valuations and the needs of a business like ours to have a mechanism for the legitimate transfer of ownership between generations.

Mr. Chairman, above all, we need certainty about our obligations, and we need a statute responsive to the needs of our market-

place. It is essential that the replacement statute be crafted carefully, so that the proverbial baby will not be thrown out with the bath water.

In conclusion, I would like to again commend you for the way you and your staff have worked with those of us most affected by 2036(c), and hope that our concerns will be addressed as a final product emerges from our cooperative effort.

We look forward to working with you as this process progresses, and thank you again for giving us the opportunity to testify before you today.

[The statement of Mr. Carlson follows:]

STATEMENT OF
DONALD W. CARLSON
CHAIRMAN OF THE BOARD
NATIONAL ASSOCIATION OF
WHOLESALE-DISTRIBUTORS

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON
2036(c) ESTATE FREEZE

April 24, 1990

I. INTRODUCTION

My name is Donald W. Carlson. I am President of Carlson Systems, a family-owned business. We are a distributor of fastening products, packaging products and equipment for manufacturing and shipping use and materials handling equipment. Our company is also a major designer and manufacturer of machines for the manufactured housing, window and door industries. Carlson Systems is headquartered in Omaha, Nebraska, and operates 33 warehouse and service centers in major cities west of the Mississippi.

I am also Chairman of the Board of the National Association of Wholesaler-Distributors (NAW) and it is in that capacity that I appear today.

NAW commends you, Mr. Chairman, and the entire Committee for holding this hearing and for the time and interest you have given to the very critical issue of estate freezes. I would also like to commend Mr. Archer for his very early efforts to resolve the enormous problems which have been created by Section 2036(c).

Mr. Chairman, last Fall you visited with NAW's Board of Directors and acknowledged at that time that a problem existed with this section of the Code and indicated that you intended to work with us and others to resolve this difficult issue. As always, you were true to your word and I would like to express my personal appreciation for your efforts. We look forward to working with you and Mr. Archer, and the other members of the committee, along with Committee staff, to reach a resolution that will be mutually acceptable.

II. THE NATIONAL ASSOCIATION OF WHOLESALE-DISTRIBUTORS AND THE WHOLESALE DISTRIBUTION INDUSTRY

NAW is a federation of 116 national wholesale distribution trade associations (a list is attached as Appendix A), 57 state and regional trade associations and 2,000 individual wholesale distribution firms. All told, NAW represents approximately 40,000 companies with 150,000 places of business. These firms range in size from those with less than \$1 million in annual sales to those with over \$13 billion.

The wholesale-distribution industry is typified by small, closely-held companies. NAW'S Distribution Research and Education Foundation estimates that well over ninety percent of wholesale-distribution firms are privately held, most of which are managed by the principal owner. The average size firm represented by NAW has approximately \$5 million in sales and employs 30 individuals.

The distribution industry experienced a rapid growth in business starts just after World War II. The entrepreneurs who started these new companies or took over the reins of family-run businesses are now at retirement age. They are now in the process of developing plans to turn their companies over to their sons and daughters. For most of them, passing on the family businesses to future generations has been a lifelong goal. Unfortunately, however, Section 2036(c) is a profoundly significant barrier to keeping a business in the family.

Studies of our industry point to a steady trend away from closely-held private corporations to more publicly and foreign-owned entities due to changing market forces and economies of scale. Quite frankly, section 2036(c) encourages a business owner to sell his or her company to an outside buyer rather than to pass it on to a family member. Additionally, Section 2036(c) causes discrimination between business owners who can simply lend cash to their children to finance the purchase of a business over a business owner whose cash is tied up in the business. As one wholesaler-distributor succinctly stated in a letter to her Congressman:

"Successful businesses such as ours are regularly solicited for purchase by Fortune 500 companies. It seems inevitable to me with the lucrative offers being made and the estate taxes that will have to be paid under the current laws, that the small family-held businesses will eventually be eliminated. I am sure that this is not the intent of Congress, but [estate] tax laws combined with aggressive larger corporations will surely lead to this end."

III. PROBLEMS WITH SECTION 2036(C)

The Revenue Act of 1987, P.L. 100-203, signed into law on December 22, 1987, added, virtually unnoticed and without public comment, Section 2036(c) to the Internal Revenue Code.

The term "valuation freeze" or "estate freeze" refers to a technique commonly used by owners of closely-held business to, for instance, give non-voting stock to children who are active in the business or to minor grandchildren who have not yet demonstrated the maturity to be involved in business decisions. Through this technique, the entire family benefits from the success of the business, but control of the business rests in the hands of those active in it.

Congress took the view in the Revenue Act of 1987 that "estate freezes" were being abused. The only official description of the "abuse" that Congress was seeking to curb with Section 2036(c) was contained in the House Ways and Means Committee report accompanying House version of the 1987 Act. The description focuses almost exclusively on recapitalizations or restructurings of business entities into "preferred" and "common" interests followed by gifts of the common interest. According to the House report, this technique:

"permits appreciation in the value of the corporate asset to pass between generations without being subject to gift or estate taxes, even though the voting and dividend rights of the preferred stock...give the owners beneficial enjoyment of the entire corporation..."

It was therefore concluded that a change in the law was necessary because "keeping a preferred stock interest in any enterprise while giving away the common stock resembles a retained life estate, and should be treated as such."

Despite the apparent clarity of the legislative purpose, the imprecision of the language in Section 2036(c) makes it susceptible to an extremely broad interpretation under which few family transactions or transactions involving family business entities are clearly outside its reach.

The most onerous result of 2036(c) is that any increase in value attributable to the assets transferred to the heirs through the typical estate freeze will revert to the parent's estate upon death, resulting in punitive taxation, even if it was through the efforts of the heirs that the value increased.

While the Technical Corrections Act of 1988 made certain clarifications to Section 2036(c) and the IRS has issued regulations, they are as ambiguous and imprecise as the original provision itself and, in fact, may have expanded both the reach of the provision and the severity of its penalties.

IV. THE CONTROVERSY OVER DEFINING ABUSIVE VALUATIONS IN A CLOSELY-HELD BUSINESS

At the heart of the controversy over estate freezes are the rules by which individual assets of a business, individual rights of a stockholder to receive future income from the business, and the rights to future appreciation of the business are valued.

Valuation lies at the heart of the estate and gift tax system since taxes are calculated based on these valuations. These questions of valuation are rendered even more complex when posed in the context of a closely-held business, for although IRS regulations specify factors to be used in determining value, value can seldom be ascertained on a mechanical basis.

Valuations for publicly-held companies are relatively easy to calculate, because the future income of a publicly-held company is generally not dependent on any one business, fashion, trend, geographic area, or person. And the value of their stock is set in a public market and can be easily found in the newspaper.

For closely-held businesses, however, valuations cannot be ascertained on a purely mechanical basis. Questions of value and the variety of rights which might be associated with a closely-held business caused the IRS to assert that there was a need to prohibit estate freezes. This view did not prevail in the courts. So, the IRS proposed Section 2036(c) to prohibit passing between generations any asset which might appreciate over time, no matter which other attributes of ownership might have passed between family members. As a result, wholesaler-distributors and other business owners are now blocked from attempting to fashion a plan for ensuring the orderly perpetuation of their businesses. The obstacles presented by current law are prohibitive whether the need is to plan for an orderly transfer of the business between generations or for a plan which provides for continuity of the business in the face of an untimely or accidental death.

V. WAYS AND MEANS DISCUSSION DRAFT

Last month, this Committee issued a discussion draft which would repeal Section 2036(c) and replace it with new statutory language. We commend the Committee for the spirit in which this draft was introduced and are committed to a cooperative effort to produce an acceptable replacement statute for Section 2036(c).

A statutory replacement for Section 2036(c) is realistic and desirable provided that it is carefully targeted to the primary abuses which 2036(c) initially sought to address. Any proposal to replace 2036(c) should, however, be limited in scope. It should focus only on preventing abusive valuations and preventing the owner of a closely-held business from passing on substantially appreciated assets without taxation.

It should also permit a business owner to craft a plan which is fair and representative of the facts in each individual situation. Such an approach must recognize the unique nature of a closely-held business which can be subject to variations in profits and income over a number of years. It must also provide for certainty in the process.

While NAW believes the proposed draft is an extremely positive first step in the process of reforming current law, we would like to state our concerns and offer our suggestions for improvements. I am sure that this Committee would like to see the best law possible enacted so that we can all have the current situation well behind us. These suggestions are offered in that spirit.

VI. DISCRETIONARY RIGHTS

First of all, the proposed limitations on various discretionary rights seem far too severe. There are circumstances in which a discretionary right is critical, even if it is never exercised. Rights to purchase common stock or to share in the future appreciation of the company with a conversion right has a determinable value which should be recognized.

We suggest that the Committee more broadly review those rights and specifically list those which are considered abusive. Clearly abusive rights should be distinguished from those rights which have a value which can be independently verified.

The rules should also be internally consistent and if a value of zero is ascribed for gift tax purposes, it should also follow that the same value should result for estate tax purposes at death. The rule should not place the IRS in such a position that it can arbitrarily disregard or include those rights when it is in their interest to do so. This potential inconsistency creates vast future uncertainties, making perpetuation planning impossible.

VII. INDEBTEDNESS CONSIDERATION

Secondly, we suggest that consideration of indebtedness be eliminated from the 80-20 calculation. Including indebtedness in this equation can cause problems because debt to deferred compensation plans, retirement plans or other qualified debt--all of which may have a perfectly valid business purpose--would have to be factored into this equation. This particular rule opens the door for the IRS to consider issues of compensation and control, which are very complex issues.

The 20% rule itself is curious for it seems to allow for the combination of preferred and common stock to have a value below that of the original equity. In our view, it places too great a reliance on increasing the value of the common stock while reducing the value of the preferred stock. If the other valuation principles are sound, we question the appropriateness of this safe harbor approach.

VIII. DETERMINATION OF RATE

Thirdly, the value of the preferred stock is also impacted by the dividend rate which the parents will receive. The chosen rate must be compared to the market rate at the time of the recapitalization, and if it is below market, the value of the preferred stock must be reduced by a percentage based upon a relationship of the actual rate to market rates. This can have the effect of increasing the value of the common stock and increasing the gift tax due at the time of the recapitalization. The definition of market rate for a security of a closely-held business should not result in a rate so high that the gift tax liability from a recapitalization would exceed the actual income tax liability from an outright sale.

Clearly, dividend rates far below market are a transparent attempt to shift value. However, requiring a rate far above market rates is equally unfair.

The fact is that requiring a rate which is too high discriminates between the business owner whose assets are tied up in his business over the business owner who is wealthier and can simply transfer cash to his children. The uncertainty is compounded by the potential zealotry of the IRS agent who may review the whole transaction ten or fifteen years after the fact. It is critical that there be some clear guidelines in the proposal on defining market rate, or, in the absence of such guidance, a consideration that the market rate be limited in some manner, similar to what has been done in the imputed interest rules.

IX. OTHER ISSUES

Additionally, the dividend payment rule requires that upon failure to pay the dividend by the third year, such debt be considered a gift and that a gift tax be due. There is no exception for hardships except for bankruptcy or liquidation. A closely-held business can find that due to changing markets or simply increased interest rates on debt that payment of a dividend is not simply a hardship, but could place the entire business at risk. Violations of loan agreements could occur and the good will of suppliers could potentially be put in danger under these circumstances. A hardship rule is necessary and important to allow a deferral of time for the dividend to be paid without triggering the gift tax and to allow the business to work out its difficulties. The Tax Code already makes such provisions available under the Earnings and Profits Test which a company must make prior to paying a regular dividend.

Of equal concern to the wholesale-distribution industry are: the additional complexities and compliance costs relating to the proposed rules on Buy-Sell Agreements outside of a recapitalization; complex elections which might be missed and need to be simplified; the requirement for mutual consent of all family members to the deemed gift rule; extension of the statute of limitations from three to six years; and, the absence of a specific list of requirements for which the statute of limitations is lifted.

X. CONCLUSION

In conclusion, Mr. Chairman, I would like to again commend you for the way you and your staff have worked with those of us most affected by 2036(c), and hope that our concerns will be addressed as a final product emerges from our cooperative effort.

We look forward to working with you as this process progresses, and thank you again for giving us the opportunity to testify before you today.

National Wholesaler-Distributor Organizations

Affiliated with the National Association of Wholesaler-Distributors

Air-conditioning & Refrigeration Wholesalers Association
American Machine Tool Distributors Association
American Supply Association
American Traffic Safety Services Association, Inc.
American Veterinary Distributors Association
Appliance Parts Distributors Association, Inc.
Associated Equipment Distributors
Association of Steel Distributors
Association of the Wall and Ceiling Industries-International
Automotive Service Industry Association
Aviation Distributors & Manufacturers Association

Bearing Specialists Association
Beauty & Barber Supply Institute, Inc.
Bicycle Wholesale Distributors Association, Inc.
Biscuit & Cracker Distributors Association

Ceramic Tile Distributors Association
Copper & Brass Servicenter Association
Council for Periodical Distributors Association
Council of Wholesaler-Distributors
National Kitchen & Bath Association

Electrical-Electronics Material Distributors Association

Farm Equipment Wholesalers Association
Fire Suppression Systems Association
Fluid Power Distributors Association, Inc.
Food Industries Suppliers Association
Food Marketing Institute
Foodservice Equipment Distributors Association

General Merchandise Distributors Council
Graphic Arts Suppliers Association

Health Industry Distributors Association
Hobby Industry Association of America

Independent Laboratory Distributors Association
Independent Medical Distributors Association
Independent X-Ray Dealers Association
Industrial Distribution Association
Institutional & Service Textile Distributors Association, Inc.
International Sanitary Supply Association
International Truck Parts Association
Irrigation Association

Machinery Dealers National Association
Material Handling Equipment Distributors Association
Motorcycle Industry Council
Music Distributors Association

National Appliance Parts Suppliers Association
National Association of Aluminum Distributors
National Association of Chemical Distributors
National Association of Container Distributors
National Association of Decorative Fabric Distributors
National Association of Electrical Distributors
National Association of Fire Equipment Distributors
National Association of Floor Covering Distributors
National Association Flour Distributors, Inc.
National Association of Hose and Accessories Distributors
National Association of Manufacturing Opticians
National Association of Marine Services, Inc.
National Association of Meat Purveyors
National Association of Plastics Distributors
National Association of Service Merchandising
National Association of Sporting Goods Wholesalers

National Association of Tobacco Distributors
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National Beer Wholesalers Association
National Building Material Distributors Association
National Business Forms Association
National Candy Wholesalers Association
National Commercial Refrigeration Sales Association
National Electronic Distributors Association
National Fastener Distributors Association
National Food Distributors Association
National Frozen Food Association
National Grocers Association
National Independent Poultry and Food Distributors Association
National Industrial Glove Distributors Association
National Insulation and Abatement Contractors Association
National Lawn & Garden Distributors Association
National Locksmith Suppliers Association
National Marine Distributors Association
National Paint Distributors, Inc.
National Paper Trade Association, Inc.
National Printing Equipment and Supply Association, Inc.
National Sash & Door Jobbers Association
National School Supply & Equipment Association
National Solid Wastes Management Association
National Spa and Pool Institute
National Truck Equipment Association
National Welding Supply Association
National Wheel & Rim Association
National Wholesale Druggists' Association
National Wholesale Furniture Association
National Wholesale Hardware Association
North American Heating & Airconditioning Wholesalers Association
North American Horticultural Supply Association
North American Wholesale Lumber Association, Inc.

Optical Laboratories Association
Outdoor Power Equipment Distributors Association

Pet Industry Distributors Association
Petroleum Equipment Institute
Petroleum Marketers Association of America
Post Card Distributors Association of North America
Power Transmission Distributors Association, Inc.

Safety Equipment Distributors Association, Inc.
Security Industry Association
Shoe Service Institute of America
Specialty Tools & Fasteners Distributors Association
Steel Service Center Institute
Suspension Specialists Association

Textile Care Allied Trades Association

United Products Formulators & Distributors Association

Video Software Dealers Association

Wallcovering Distributors Association
Warehouse Distributors Association for
Leisure and Mobile Products, Inc.
Water and Sewer Distributors of America
Wholesale Florists & Florist Suppliers of America
Wholesale Stationers' Association, Inc.
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Chairman ROSTENKOWSKI. Mr. Dubin.

STATEMENT OF STEVEN H. DUBIN, PRINCIPAL, WILLIAM & DUBIN, INC., QUINCY, MA, REPRESENTING NATIONAL SMALL BUSINESS UNITED

Mr. DUBIN. Thank you very much.

I am a principal in a small business firm in Quincy, MA, which specializes in business continuity and estate planning or what I would call bread and butter family businesses.

As I tried to illustrate in my written testimony, for my clients, 2036(c) is a nightmare. Normal intrafamily business transactions have to be put under the tax microscope for detection of inadvertently created prescribed business interests.

It is with a great deal of relief that I see the focus in this area shifting from the inappropriate extension of the principles of section 2036 (a) and (b) in business dealings to correcting credible evaluation abuses. I support and we support the spirit of this draft legislation.

I wonder whether or not that spirit could be embodied in a somewhat similar form. I would like to commend the draft proposal I had chance to review from David Barnett of the U.S. Chamber which I think is a continuation of distillation of the spirit.

We agree with, I think, all the previous speakers that the use of meretricious rights features to artificially inflate the value of a preferred interest so that the common growth interest can be undervalued for interfamily transfer purposes is an abuse.

I would like to take a look at the implications and suggest the abuse is principally one of timing.

The estate and gift tax are a unified structure. If I divide a business into two interests, common and preferred, if I overvalue the preferred, that will be caught in my estate at its overvalued price.

What I am doing is not paying a gift tax perhaps on the undervalued common up front. The example I give in my papers to take a business worth \$1 million to create a preferred stock I claim to be worth \$900,000 and give away the common for \$100,000, assuming a 50 percent transfer tax cost, I am paying \$50,000 up front to give away the common and I am leaving \$900,000 in my estate for a \$450,000 bill, and there is a half million of total taxes.

If, for instance, I had overvalued the preferred and was only worth \$600,000, I would have paid \$200,000 in gift taxes on transferring the common and \$300,000 in retained estate taxes for the same 500. The difference is when Treasury gets the money.

If that is the case, to make Treasury even as it were, what I suggest is that dividends that approximate the rate of inflation be appropriate. That is going to get its money as it goes along by getting a common start dollar whether it got it up front or whether it gets it later, it gets a constant dollar.

The general principle of the draft legislation which would either be to subject missing dividends to a current gift tax or to include them later on in a compound basis makes sense.

I am just suggesting that the measure of compounding and also the measure what the dividend should be geared to the inflation rate and Treasury as a whole.

I would like to point out that although they are given the same name, preferred stock in a private and a public business serve two different purposes. In a public business, it is used to attract money. In a private business it is used to account for money already committed.

If we adopt the thesis that Treasury needs to be made whole in order to prevent abuse, it doesn't seem to me to make much difference whether we have minimum coverage requirements or not as long as Treasury is going to get its transfer taxes and money isn't leaking out of the system and it is getting a time—the time adjusted value with money, then whether or not the preferred is deemed to be worth 90 or 80 percent of the enterprise becomes somewhat irrelevant and it frees up some complications that occur with an 80 percent minimum coverage rule.

For instance, what happens if I own 90 percent of the preferred stock and my children own 10—excuse me—of the common stock and my children own 10 and I exchange all of my common for preferred, have I made a deemed gift to them? Do I have to take 10 percent of the common.

In multi-tiered structures, how do we measure it that well?

I would also think that that, by requiring that a preferred instrument carry a rate of yield on it, that is somewhat constant with inflation and geared to inflation, we can value an instrument coming and going the same way. One of the difficulties, I think in the current proposal, is the fact that it requires you not only to identify instruments that are going to be valued under the so-called QFB rules, but you have to identify the type of transaction in which they occur.

If the stock is moving, interest is moving in one direction, one set of valuation rules apply. If it is moving in another, another set of valuation rules apply. I think that gives rise to a lot of problems.

I would prefer a structure, and I think one can be made, where you have parallels throughout.

My last comment is that I don't think that the issue of buy-sells is really appropriately included in this context. That is an issue where the business itself perhaps could be undervalued but not one interest being under or overvalued relatively to another. I think it can be addressed under 2033 or elsewhere.

It is just mucking up the waters in this particular context.

Thank you very much.

[The statement of Mr. Dubin follows:]

Statement of Steven H. Dubin
before the House Ways and Means Committee
regarding estate freeze provisions of the Internal Revenue Code
on behalf of National Small Business United
April 24, 1990

Mr. Chairman and Members of the Committee:

Good morning. My name is Steven H. Dubin, and I am an estate planning specialist out of Quincy, Massachusetts. I am very pleased to be here this morning to testify on behalf of National Small Business United regarding Subsection 2036(c) of the Internal Revenue Code. This section of the code has been devastating to the estate plans of many small family-owned businesses. We are, however, very pleased that this Committee has expressed such great interest in putting forth a more workable alternative to the current situation; we believe that we have some helpful comments to that end.

As you may well know, National Small Business United (NSBU) is the oldest association exclusively representing this country's small business community--for over 50 years now. NSBU is a volunteer-driven association of small businesses from across the country, founded from a merger of the National Small Business Association and Small Business United. NSBU serves some 50,000 individual companies with members in each of the 50 states, as well as local, state, and regional associations.

Let me give some examples to illustrate the problems with 2036(c). Let us say that I own 100% of Corporation X, which is currently valued at \$1.0 million. X has one class of stock: common. I give or sell 10% of my shares to my heir. At more or less the same time, I might exchange my retained 90% of the common for a new class of preferred stock, which will have a liquidation/participation ceiling (of \$900,000) that will "freeze" its value. Over time, the business appreciates to be worth \$2.5 million.

If I do not recapitalize, and the business is sold during my life, I will receive \$2.25 million ($\$2.5M \times 90\%$). If I discover that I bet on the wrong heir, it will cost me \$250,000 to buy him or her out. And if I die having neither sold the business nor bought out my heir, \$2.25 million will be includible in my estate.

If I do recapitalize, and the business is sold during my life, I would only receive \$900,000. If I had to buy out my heir, it would cost me \$1.6 million! And if I die having neither sold the

business nor bought out my heir, includible in my estate would be:
 1) \$900,000 pre 2036(c); 2) something slightly less than \$2.25 million under 2036(c).

Obviously, the recapitalization "freeze" has significant economic consequences during one's life, and it has been my experience that the potential estate tax savings (pre 2036(c)) was more often than not outweighed by the very real lifetime give-up. And if 2036(c) was limited in its application only to "estate tax freeze" recapitalizations, I would object to it on these grounds alone. But for 2036(c) to be anything more than an avoidable pitfall in the path of estate planners, it has to encompass all the possible ways in which the results of an estate tax freeze can be obtained indirectly: through tiered structures, family partnerships, holding trusts, leasing agreements, etc. And like any net spread over so much ocean, it is likely to catch a good many dolphin with the tuna. For instance:

I have a client who wishes to retire, and is in the process of selling--to a son in the business--his stock; all of it. To supplement his retirement income (and ultimately to provide an "equivalent" inheritance to his inactive children) he is retaining the real estate in which the business operates. The son would like to keep the lease payments on the modest side; dad would like them a bit heftier. In the bigger world, this kind of issue is negotiated every day with a participating lease; base terms are modest, but the lesser participates in business sales or profits. In the targeted world of small family businesses, a participating lease falls afoul of the 2036(c) dragnet (disguised frozen equity?), and my client would run the risk of the entire value of the business, less any consideration from son, being dragged vicariously into his ultimate estate! Actually, until the first round of regulations were issued, we were not even sure any kind of lease was not problematic. And while we are at it, better check to make sure that if son is buying out dad over time, the installment terms fit neatly within the prescribed safe harbor (installment notes having the potential to be disguised frozen equity). And even if we want to compensate dad for periodic consulting services to the corporation, we had better make sure his contract and payments are not for more than three years and are not tied to company performance: consulting/compensation agreements are also a proscribed end-run around the 2036(c) statute.

Is 2036(c) fixable? I think not. Even in its simplest / narrowest case, it ignores the economic reality that the sword of bifurcation cuts both ways. When a business owner agrees to freeze his participation in the future appreciation of the business, he limits his benefit if the business is sold, and increases his exposure if he has to buy back a non-frozen interest. 2036(c) also ignores the contributions that the next generation may make in growing the business, primarily because there is no way to quantify this. In fact, it actually discourages such initiative,

at least until "old dad" has passed on and the business can be safely grown without its growth being vicariously taxed in dad's estate at fifty to sixty cents on the dollar!

So it is with great relief that I see Treasury and this Committee re-examining this area and concluding that there is no abuse inherent in transactions which "freeze" value except to the extent of valuation abuse. In the estate freeze context, valuation abuse arises from over-valuing the fixed instrument, thus making it less expensive to sell or give away the growth. One of the simplest ways to do this is to assign to the preferred a non-cumulative dividend preference great enough to substantiate its postulated value, then not paying dividends. Not only has the inflated value of the preferred made it less expensive to sell or transfer the common, but the lack of dividends inure to the benefit of the corporation, and specifically the holders of the common, or growth, interests.

The use of meretricious rights / features to artificially inflate the value of a preferred interest so that the common / growth interest can be undervalued for intra-family transfer purposes is clearly an abuse. But let us consider its implications. By over-valuing the preferred, we are increasing the estate tax exposure of the holder and saving some up front transfer tax costs. Gift and estate tax rates being the same, the loss to Treasury is first one of timing: Treasury taxing value later rather than sooner. For instance, assume the recapitalization of a \$1.0 million business. Some "bells and whistles" are hung on the preferred to substantiate a \$900,000 value; without those bells and whistles, it would be worth \$600,000. The transfer tax value of the common would be \$100,000 if the preferred's higher value is recognized; \$400,000 otherwise; assuming all transfers were in the 50% marginal bracket, the donor would pay \$50,000 in gift taxes in the first case; and \$200,000 in case two. However, at the donor's death, the preferred stock would cause \$450,000 in estate taxes in the first case, and \$300,000 in case two. Total transfer taxes in each case is \$500,000. And earlier disposition of the preferred only accelerates the donor's tax consequences.

A reasonable way to counterbalance the timing loss to the fisc is to require the preferred to pay dividends: Treasury picking up in income tax what it might be losing in forgone time value of money, but at what rate? In light of the foregoing analysis, it seems that all Treasury needs to break even is a rate sufficient to provide it with a constant dollar--the inflation rate. In this context, it is worth noting that while given the same name, preferred interests in a private and public business serve two different purposes entirely: one is used to account for money invested, the other is to attract money for investment. If the purpose of a valuation statute to replace 2036(c) is to assure that Treasury is not taken advantage of, then a yield rate tied to inflation should be satisfactory.

Under the proposal on the table, the non-payment of the stipulated yield will either compound (at ?) to be added into the donor's ultimate estate, or the donor can recognize a gift in the amount of the forgone yield in the year in which it occurs. Presumably, these "phantom" consequences would be adjusted in proportion to the benefit conveyed on the donor's family as opposed to unrelated parties where a business might not be held entirely by one family/family line. This does not seem unreasonable. However, it should be noted that under some circumstances, state law and/or creditor agreements may prohibit dividend distributions. While the current proposal provides a three-year period to make up a missed distribution, it makes no provision for economic hardship. It is suggested that a hardship petition provision be included, similar to the waiver of minimum funding provisions allowed qualified retirement plans. It is also suggested that payments in excess of the stipulated amount made in any year be given carry forward credit; this is just paying the Treasury its time value of money sooner rather than later.

In this spirit, it seems somewhat unnecessary to have minimum coverage rules. The current proposal mandates that the preferred interest cannot at creation consume any more than 80% of the business' valuation. If Treasury receives the same constant dollar value as discussed above, then where is the abuse in maximizing the current value of the business reflected in the preferred? If the argument is that the business will grow faster than inflation and thus by maximizing the amount/value of the preferred for which an inflation adjusted cost is paid, we are illegitimately shifting value. The counter argument is that this arbitrage only means that the business is functioning productively--creating value from opportunity, which as a general policy matter is obviously desirable. Furthermore, the minimum coverage rules present application problems in tiered and related businesses, and in situations where common interests may already be owned by family members. For instance, how should the 80% rule apply where son owns 10% of the common stock when dad exchanges his 90% for a new class of preferred? Must dad continue to retain 10% of the common? If he does not, has he made a vicarious gift of 10% of the business' worth to son? Is it really necessary to have a rule which creates this problem?

I would also submit that the adoption of this single requirement that a preferred instrument provide for an inflation related yield to substantiate value would obviate the difficulties and complexities associated with the dual valuation principles under the proposed law. The proposed law values preferred interests according to yield when such interests are sold or transferred in a tax freeze context, but according to general valuation principles otherwise. This, of course, is necessary so that taxpayers could not turn the law on its end and beat the Treasury by giving away for their mandated zero value, preferred instruments with no fixed yield. But it means that the type of transaction must now be scrutinized, along with the instruments. It also means that adjustments will have to be made when an

instrument is valued one way at one time, but another way at another time. Would it not be simpler to apply long-standing valuation principles to all preferred interests, with the proviso that the instrument must bear or pay an inflation rate yield to substantiate value?

Finally, I would address the issue of buy-sell agreements, which are included in the proposed anti-valuation abuse statute. I would suggest that they are out of place here. The "abuse" potential of buy-sell agreements is that they can artificially deflate the value of the business itself, and its component interests. This is not an issue of creative over-valuation of one class of interest to smuggle value out through another. In my opinion, the only reason to have an anti-valuation abuse statute as set forth above in the context of preferred interest freezes is to create a statutory mechanism for dealing with defaults of payment of requisite yield, remedies, and related matters. Otherwise, one could easily graft the principles into the valuation regulations under 2033, for instance. The requirement that the buy-sell value be "reasonable" when created adds nothing to existing law. The requirement that the value be "refreshed" within three years of the agreement's triggering is primarily a trap for the unwary; but perhaps serves a purpose in assuring that once reasonable values do not become purposefully or carelessly outdated. If so, it would be easy enough to incorporate this into the applicable regulations elsewhere, or to issue a revenue ruling on the point. But before any action is taken, I would ask that the effect of this "three year review" be considered in the context of legitimate option agreements of longer duration. For instance, suppose dad gave (or sold for an appropriate price) an option for son to buy out dad's interest in X for \$2.0 million when the current value of dad's interest in X is \$1.0 million. The option is exercisable at any time over the next ten years. Six years from the time the agreement is entered into, dad's interest in X is worth \$2.5 million. If exercised by son, is there \$500,000 in unexpected gift consequences?

The issue of what a private business is worth, with or without any additional guidance from the Service, will always be problematic. By and large, the Service has done very well in the courts litigating abuses in this arena. I would point out that the most infamous current buy-sell valuation case undoubtedly that of the Estate of Hall and that even if the proposal under consideration had been law, the result of the case (favorable for the taxpayer) would not have been altered. The buy-sell is a *sin qua non* of private business continuity planning; shareholders and partners have to know what their respective liabilities to each other are in the case of a falling out or death among them. More so than in a public business, the very fact that one of their members retires or dies can, in itself, depress business value. I think the Service has been generally fair minded in this area, and taxpayers likewise. In the case of the latter, self-interest

if nothing else rises above tax savings; either I, as a co-owner, want to protect my spouse, or want to assure there is enough money around to "balance" my estate between active and inactive heirs.

I want to thank the Committee for having this hearing today, and for putting forth a proposal to replace 2036(c) which starts us down the right path. I hope my comments are helpful toward finding a more acceptable alternative for small business. We stand ready if we can be of further assistance.

Chairman ROSTENKOWSKI. Mr. Zaucha.

STATEMENT OF THOMAS K. ZAUCHA, CHAIRMAN, SMALL BUSINESS LEGISLATIVE COUNCIL; AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL GROCERS ASSOCIATION

Mr. ZAUCHA. My name is Tom Zaucha. I am president of the National Grocers Association, a trade association here in Washington, whose mission is exclusively devoted to the interest of the independent grocer.

Today, I am testifying as chairman of the Small Business Legislative Council, a coalition of over 100 different trade associations that represents all segments of commerce in the United States.

Mr. Chairman, in my testimony today, I would like to travel two roads with you. One involves the journey from the past to the present. It is a tragic trip which millions of family-owned businesses have been forced to take against their wills due to the enactment and force of the IRS Code 2036(c).

But I am happy to recognize what I see here today as a second road, the possibility of a new journey for all of us to undertake. Let me look at this from three perspectives. The first is the process.

The past 4 months have witnessed a number of candid and productive discussions between Treasury, members of this committee and the small business community. In particular, Assistant Treasury Secretary Ken Gideon, has thus far been open, forthright and responsive in his approach to tax reform.

Similarly worthy of particular commendation was the action of this committee in releasing a discussion draft of major 2036(c) modifications. SBLC is especially pleased that 2036(c) would be retroactively repealed.

The announcement by you, Mr. Chairman, of today's hearing was yet another step in that right direction. Your desire to obtain an informed discussion about possible modifications of 2036(c) that would address legitimate complaints about the current law provisions is on target.

In addition, SBLC is especially encouraged that now 218 Members of the House have joined with Representative Bill Archer in cosponsoring H.R. 60 to repeal 2036(c). All of this willingness by the administration, the Congress and business community to work together to create a solution to this crisis represents the high road, one that is marked by an open and constructive process.

Now, Mr. Chairman, members of the committee, this hearing will very, very well document the inherent flaws that permeate 2036(c). I think there is little question among anybody that ultimately, it must be repealed. But I think the question we must ask ourselves and document for the record is what have been the results in the real world of the flaws of 2036(c).

First, it is important to understand that a vital component of the American system and our national prosperity has always been the family business. From this country's farms and ranches to the grocery store to a wide variety of enterprises which have proudly borne their family names for generations, independent family business has been at the very foundation of our country.

This is powerfully attested to by the fact that heretofore, Congress has consistently encouraged and sought to strengthen such family involvement. Having said this, we must understand that section 2036(c) dangerously reverses the proven historical record and presumption in favor of the family business and its role in our economy.

Mr. Chairman and members of the committee, I think I can bring home to you these consequences by sharing some real-life examples drawn from our own membership. I can assure you that such test cases are being repeated over and over again every single day.

To illustrate this, I go back to last fall, where Tom Goodner, an owner and operator of Goodner's Supermarket in Duncan, Oklahoma, told the Senate Small Business Committee the effects of 2036(c) on the four-store operation that was started by his father 52 years ago. He said the following: "I felt it necessary to initiate my estate planning process with our own counsel, but we were stopped dead in our tracks by the hazards of 2036(c)." As another example, consider Chuck and Don Butson of New Hampshire, whose parents started a business almost 40 years ago. When they tried to undergo the planning process, the Butsons told us that after 40 years of active involvement by their parents in the business, the hardest step was to inform their 71-year-old father that he must sever his relationship with the company if the company was going to survive.

We go to another example in Ohio. A one-store operator with five daughters who wanted to continue in the family business. At this point in time, they have had to stop their estate planning and in the event of the death of the owner, they are afraid they are going to have to sell the business.

In Cynthiana, KY, a grocer with four stores and six children, four of whom want to stay in the business. In his words, "We don't know what steps we can properly take. Section 2036(c) goes too far. My children have worked hard and long for the growth of our business and are entitled to own it. My biggest fear if Congress doesn't fix it right, we will be forced to sell the business."

Mr. Chairman, where do we go from here? We think that the draft presented by the staff and Treasury is a good first step but in its current form, we cannot support the draft. We have offered for the record 18 specific technical improvements based on three standards.

One, the standards of it are still too broad, and we can reduce the breadth and scope of the draft. No. 2, on the basis of equity and fairness, we think improvements can still be made; and, third, with regard to the overall efficiency and the complexity of the current law in the draft, improvements can be made.

Mr. Richard Dees, who will be on the next panel, will be prepared to talk in depth about these 18 specific recommendations. Thank you very much.

[The statement of Mr. Zaucha follows:]



STATEMENT OF
 THOMAS K. ZAUCHA, CHAIRMAN OF
 THE SMALL BUSINESS LEGISLATIVE COUNCIL,
 ON THE "DISCUSSION DRAFT"
 RELATING TO ESTATE VALUATION FREEZES
 BEFORE THE COMMITTEE ON WAYS AND MEANS,
 U.S. HOUSE OF REPRESENTATIVES,
 APRIL 24, 1990

Mr. Chairman my name is Thomas K. Zaucha and I presently serve as the 1990 Chairman of the Small Business Legislative Council and as President and CEO of the National Grocers Association. I very much appreciate this opportunity to testify on behalf of both organizations concerning a subject of major importance to all of us: the legislative future of Internal Revenue Code Section 2036(c).

As you know, the Small Business Legislative Council (SBLC) is a permanent, independent coalition of over one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached.

The National Grocers Association has always been an active, vital member of the SBLC. We include over 2500 retail and wholesale grocery companies operating throughout the United States. N.G.A.'s retail members are predominately independent operators that are family owned and closely held businesses encompassing supermarkets, grocery stores and convenience stores to serve the American consumer. N.G.A.'s wholesale members serve as the food distributors to these retail grocers.

Mr. Chairman, in my testimony today I want to travel two roads with you. One involves the journey of the past to the present. A tragic trip which millions of small, family-held businesses have been forced to take against their wills, due to the enactment and force of IRS Code, Section 2036(c). But I am happy to recognize what I see here today as a second road. The possibility of a new journey for all of us to undertake.

Let me look at it from three perspectives. First, and today most important, is the process. The past four months have witnessed a number of candid and productive discussions between Treasury, members of this committee and the small business community. In particular Assistant Treasury Secretary Kenneth Gideon has, thus far, been open forthright and responsive in his approach to tax reform. Similarly worthy of particular commendation was the action of this committee in releasing a "Discussion Draft" of major 2036(c) modifications. SBLC is especially pleased that Section 2036(c) would be retroactively repealed.

The announcement by Chairman Rostenkowski of today's hearing was yet another step in the right direction. His desire to obtain "an informed discussion about possible modifications to 2036(c) that would address legitimate complaints about the current law provisions..." is on target. In addition SBLC is especially encouraged that now 218 members of the House have joined with Representative Bill Archer (R-TX) in cosponsoring H.R. 60 to repeal Section 2036(c). All of this willingness by the

Administration, the Congress and the business community to work together to create a desperately needed solution to this crisis represents the high road-one that is marked by an open and constructive process.

Now, I would like to turn immediately to my technical discussion of 2036(c) as it exists today and as it would be replaced by the Committee's draft language. While I do not have the time here to spell out all of the technical difficulties with Section 2036(c). Suffice it to say that they are indeed numerous in nature. However, among the most important I would include:

First, Section 2036(c) is unworkable among other reasons because it relies on the notion of "disproportionate appreciation." All business assets appreciate at different rates so the concept is meaningless. This concept is particularly harsh on unincorporated family businesses because of the possibility that any gift of business assets might be caught by Section 2036(c) because the gift was not of fractional share of every asset used in the family business. Nearly any gift in the family business context had potential unexpected adverse tax consequences.

Second, Section 2036(c) is not limited to gifts, but it impacts legitimate business transactions without an estate planning motive, for example, buy-sell agreements, debt, leases, and employment agreements. The same transactions which would be permitted General Motors would not be permitted a general Motors dealer. Legitimate business transactions could result in the inclusion of a portion of the common stock owned by a child in the estate of a parent. Efforts in 1988 to narrow the scope of Section 2036(c) through "cookie cutter" rules failed to take account of the diversity of family businesses.

Moreover, the estate tax penalty from that inclusion is unrelated to the transaction. The appreciation in value could have been due entirely to the child's efforts in the business. Section 2036(c) is faulty because it was "an estate tax solution to a gift tax problem." It also unfairly imposed both a gift and an estate tax on the same transaction.

Finally, Section 2036(c) attacked family cooperation in the guise of preventing "hidden giving." Section 2036(c) ascribed adverse estate tax consequences to a parent who helped a child start his own business. Section 2036(c) favors parents who completely separate from the family business prior to death. It discriminates against family businesses in favor of wealth in public or foreign corporations.

At this point, it is probably wise to note that 2036(c), as finally drafted, bears little meaningful relationship to the narrow, restricted "abuse" it was brought forth to correct. Remember, the prototypical "freeze" involved the recapitalization of a wholly owned corporation into two classes of stock: a preferred class which had a preference for dividend payments and on liquidation and a common class which was junior, but had a right to appreciation over the stated value ("frozen value") of the preferred. The dividends on the preferred was artificially supported by a redemption right, a conversion right or a power to liquidate the company. These rights were never actually exercised so that over time the value of the preferred was frozen at its initial stated value. Moreover, the unpaid dividends accumulated in the company to the benefit of the common shareholders. Using time value of money concepts, the dividend payments if deferred into perpetuity approached a present value of zero. The actual present value was never that low as the life expectancy of the parent was often short and the frozen value of the preferred would be taxed in the parent's estate.

To restate Section 2036(c) involved four elements all of which were necessary: (1) "frozen" value stock held by a parent, (2) using unexercised conversion, redemption or liquidation rights to artificially support the preferred's value, (3) the failure to pay the expected dividends on the preferred, (4) which accrued to the benefit of the children who held the common.

What have been the results of the flaws of Section 2036(c)? First, it is important to understand that a vital component of the American economic system and our national prosperity has always been the family business. From this nation's farms and ranches to the corner family grocery store to a wide variety of enterprises which have proudly borne their family names for generations, independent family business has been at the very foundation of our country. This is powerfully attested to by the fact that heretofore Congress has consistently encouraged and sought to strengthen such family involvement.

Having said this, we must understand next, that Section 2036(c) dangerously reverses the proven historical record and presumption in favor of the family business and its role in our economy.

Under its current provisions, parents may work long and hard years, motivated in great measure by the opportunity to build and pass on a true family business, only to see all such efforts defeated by the need to sell much or all of the enterprise to pay the tax collector's bill. Of course, it is important to combat any and all abuses of our tax code. But these must be narrowly defined and targeted. The current law, however admirable its purpose, paints with far too broad a legal brush.

In so doing, it is counterproductive to vital national economic goals which have long been promoted by prosperous family enterprises. Certainly, to the extent that these two goals or purposes seem in conflict, there can be no question that the promotion of the family economic contribution deserves clear precedence.

But, secondly, please think of this on an individual basis. Family owned businesses are not short-term concerns. A real family sees itself as a closely bound, dynamic entity yesterday, today, and tomorrow. The realistic potential of meaningful passage of a business from one generation to another is often the principal motivation for the ongoing prosperity. We say that family business is both "owned and operated:" advisedly, and expansion of a true family enterprise. For the present generation, the prospect of future appreciation represents a great legacy to his or her children. It also frequently represents a personal guarantee of retirement security. In both instances, again and again we must acknowledge that it often partially or totally sustains the actual day to day business operation. Operations, which when multiplied by the millions of family owners, are a central facet of our entire national economic life. But now, because of the confusion and risks which these tax code provisions have created, we find that everywhere legitimate intrafamily transactions and estate plans have ground to a halt. Lawyers, accountants and financial planners may well be kept busy dispensing costly advice, but the thousands of family owned and operated businesses which so profit this country cannot long exist in such an economic limbo. A prompt and clear restoration is a necessity.

Perhaps I can best "bring home" to you these consequences by sharing some "real life" examples drawn from my own members. I can assure you that such "test cases" are being repeated over and over and over again every single day.

To illustrate the onerous and substantial impact of Section 2036(c) on family owned businesses, N.G.A. has received reactions

from grocers throughout the country. Some representative examples follow:

Last fall, Tom Goodner, owner and operator of Goodner's Supermarkets in Duncan, Oklahoma vividly told the Senate Small Business Committee the effect of Section 2036(c) on the four store operation that was started by his father 52 years ago. He had planned to pass the business on to his son and had initiated estate planning in December 1989. Mr. Goodner said, "I felt it necessary to initiate my estate planning process with our own counsel. But we were stopped dead in our tracks by the hazards of Section 2036(c)."

In Woodsville, New Hampshire, Chuck and Don Butson are the owners of Butson's Supermarkets. Their parents started the business almost 40 years ago and had begun the process of transferring the business to the second generation in the 1980's. Under the law prior to Section 2036(c), the family had taken substantial steps to obtain a business appraisal and undertake legitimate estate planning, including a partnership freeze. However, unfortunately in 1987 Section 2036(c) required a substantial reevaluation of the family's estate plan. As a result, the Butsons' had to go beyond the company to finance its purchase from their parents, thus, terminating any debt or compensation that was accruing to them. The Butsons told us that after 40 years of active involvement by their parents in the business the hardest step was to inform their 71 year old father that he must sever his relationship with the company if the company was going to survive. Advice of counsel had made clear that the outside financing was necessary to replace the loan held by their parents. Indeed, they emphasized, the only thing making this transfer even possible was the parents' commitment to transferring the business to the next generation, and their willingness to step aside for their sons. Equally detrimental was the fact that this whole process had to be undertaken with substantial income tax consequences to the parents. Worse still was the adverse estate tax planning to his mother. Upon Mr. Butson senior's death last December, the mother had to forego any stepped up basis in stock to which she had previously been entitled. In the words of Chuck Butson "Section 2036(c) created substantial and unnecessary legal and tax expenses. The passage of Section 2036(c) without any legislative hearings or fair notice to those affected gave no consideration for the planning we had already undertaken for an orderly transition within our family owned business. Congress should be pro family not anti-family."

Likewise, in New Philadelphia, Ohio, James A. Stoll, the owner of a single store is a second generation grocer. He began in the business as a teenager with his father and took over the business as a young man when his father died. With five daughters who each own 24 of the stock in the company, Mr. Stoll and his wife, the majority owners, had begun to plan for the transfer of the business to the third generation. In 1987 Section 2036(c) drastically forestalled all of the estate planning which they had in mind. Assurance of an orderly transition of the business to the third generation was put "on hold." Mr. Stoll's overall assessment: "We don't know at all to what we are entitled under Section 2036(c). Our biggest fear is that we may ultimately be forced to sell. We can no longer count on passing the business on to the next generation. I cannot understand what the government could have been thinking of in passing this ill conceived law."

In Cynthia, Kentucky, the fear of Section 2036(c) is equally chilling. Ken Techau owner of Ken's New Market has six children, four of whom are actively involved in the business, to whom he wants to pass on the business. The excessive reach and uncertainty of Section 2036(c) has caused Mr. Techau great concern because part of his business succession plan involves a buy-sell agreement. In his words, "We don't know what steps we

can properly take. Section 2036(c) goes too far. My children have worked hard and long for the growth of our business and are entitled to own it. My biggest fear is that if Congress doesn't fix it right, we will be forced to sell the business."

In the face of countless such examples I was not surprised to read the headline in one recent Wall Street Journal article; which graphically proclaimed: "Inheritance Tax is Choking Successors to Family Firms/Removal of Estate-Tax Freeze Puts Big Burden on Small Business"

We know that in some 20 million cases current laws make it difficult to pass on small family business without enormous, even devastating taxes. In fact for many, we here today are too late. The Journal reports that "Accountants say that thousands of businesses already have been sold after being hit with the tax burden."

Throughout 1988 and 1989, the SBLC, N.G.A. and numerous other concerned citizens and groups turned to our government for help. Too little was forthcoming. What message did we receive? "The best advice I can give small businessmen this year is not to die," was what we heard from a legislative aide to Senator John Heinz (R-PA). Consolation for the medical practice but not the accountant.

But, as I emphasized at the outset of my testimony, I am happy to recognize what I see here today presents an opportunity for constructive resolution to a serious problem for family owned businesses.

Our immediate concern is that this significantly improved process be fully utilized by all the concerned parties to produce significantly better tax policy. That brings me to an actual evaluation of the "Discussion Draft" now "on the table" in front of all of us. As my subsequent comments will make clear, both the SBLC and N.G.A. must express many reservations with the committee draft, a number of them quite serious in nature. As it exists, it cannot be said to succeed. However, we are pleased to offer our specific comments and suggestions as a vital part of the cooperative, constructive process which we now see as emerging.

Permit me to now submit both our general reactions to the direction of the Discussion Draft and a number of specific comments upon its content.

Drafting a replacement to current Section 2036(c) means identifying and guarding against the potential abuses without discrimination against family businesses. That is a delicate balance, but one which it should be possible to achieve. The Discussion Draft (the "Proposal") is based on a framework which could serve as a basis for such a replacement. First, it provides that preferred equity interests should be valued solely by reference to real economic rights, rather than meretricious, artificial rights. Second, that the failure to exercise rights in an arms-length manner should result in a gift.

While the Proposal is an acceptable starting point for replacing current Section 2036(c), in its details it contains many of the same faults of the existing statute. These problems make the current Proposal unacceptable. Treasury and Staff appear receptive to the concerns which have been raised and appear committed to developing an acceptable statutory scheme to eliminate the abuses which spawned Section 2036(c) without unfairly imposing on family businesses. Such an alternative would have wide support.

Market Testing Rate

It is clear that the Proposal or any variation of it will end "freezes." The parent who retains the preferred while the child has the common will annually (1) be paid a dividend, (2) be treated as making a gift equal to the unpaid dividend or (3) have increased value in his or her estate through compounding. This thav will be determined by the "market testing rate."

The replacement contains no mechanism for determining the market testing rate. However, the rate should not be higher than the applicable federal rate ("AFR") which is the required rate on intrafamily loans. First, the proposal assumes that the stated dividends will be paid. This eliminates any need for a higher rate to account for risk, dividend coverage, or lack of marketability. The AFR represents a safe taxable rate of return.

Second, a higher rate would discriminate against family businesses in favor of investors. A wealthy individual can loan cash to a child to buy a business (or growth stock) and need only receive interest at the AFR.

Third, a higher rate suggests an attempt to go after the presumed greater return from families which work and invest together. This attempt is frequently phrased as an "attack on hidden giving."

Finally, the current non-deductibility of dividend payments should indicate a lower rate. "Blue Chip" corporate preferred stock often carries a rate lower than AFR.

Moreover, a lower testing rate than the AFR encourages the use of preferred stock as a means of business succession. It further allows the conservation of capital by family businesses so that these businesses are more productive, more competitive and ultimately pay more taxes.

The ideal market testing rate would account for these factors and would be less than 66% of AFR, reflecting reduction for the federal corporate tax rate.

Specific Comments on the Proposal

In addition to our concern about the market testing rate, we also have specific comments on the technical problems with the Proposal. These problems can be divided into three categories: (1) problems related to overly broad application of the replacement, (2) fairness or (3) complexity and efficiency. The following listing of technical problems is in no specific order nor is the list intended to be all-inclusive.

Problems Related to an Overly-Broad Application

Buy-Sell Agreements. Section 2702 of the draft statute is a separate part of the Proposal dealing specifically with buy-sell agreements and bears no relationship to the abuse which prompted Section 2036(c). The Treasury Regulations 20.2031-2(h) set forth a rule which appropriately balances the legitimate business objectives of family business owners against the federal fisc:

the option or contract price...will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

The Regulation permits Treasury to ignore options in buy-sells which have an estate planning motive rather than a business motive. For example, the courts have backed Treasury when it

ignored an option formula which produced a \$0 value. A common situation is a parent selling the business to an active child at a fixed formula price derived in arms-length negotiations. If that agreement is not honored by the estate tax rules, unexpected and adverse tax consequences will result either to the purchasing child or the inactive children according to where the tax burden falls. Moreover, that tax burden being unknown will be impossible to plan for.

In addition, according to Gary Crawford an estate and tax adviser for Super Valu, a food wholesaler in Minneapolis, Minnesota, who counsels their retail customers:

"Numerous plans in progress were halted when 2036(c) was adopted. None of these plans involved the use of preferred stock or other "freeze" techniques. For example, in six of these plans each of the retailers wanted to engage in a program to give voting and non-voting common stock to his children while he continued to be actively employed in the business. Each plan included a buy-sell agreement designed to transfer a controlling interest in the business to the children who were active in the management of the business. We could not proceed with any of these plans because of the large degree of uncertainty created by 2036(c) with respect to the tax consequences of the gifting program and the buy-sell agreements. After IRS published Notice 88-99, we were able to proceed with these plans cautiously, but with a large degree of uncertainty remaining with respect to the tax consequences of the provisions of Section 2036(c) relating to buy-sell agreements.

The proposed Chapter 14, continues to create uncertainty and impose special rules on family business transfers under buy-sell agreements or pursuant to redemptions. Virtually every ownership succession plan for a retailer involved the use of a buy-sell agreement to transfer shares to the children that are active in the business i[n] the retailer's death. The transfer under the buy-sell agreement in is likely to take place through a redemption of the retailer's shares by the corporation. Hundreds of our retailers (mostly one to two store moderate sized business) have such plans in effect. These are common ordinary ownership succession planning arrangements, and to be effective, a high degree of certainty as to the tax consequences of such arrangements is essential. If Chapter 14 becomes law, most of our plans with buy-sell agreements will have to be revised substantially to attempt to avoid unexpected gift or death taxes, and many plans may be abandoned due to the uncertainty of the tax consequences."

If there is a legitimate concern about abuse of fixed price buy-sells which is not reflected in the reported cases, Section 2702 goes too far when it ignores rights of first refusal and leases in determining value for transfer tax purposes. Rights of first refusal and other transfer restrictions are always present in privately-held businesses. These rights do not fix value for estate tax purposes so that there is no "freeze" potential. However, like other aspects of ownership of stock in a private business, such as SEC restrictions, minority voting and lack of marketability, these restrictions depress value. It is discriminatory to ignore the value depressant effect of these rights when held by close family members, but to recognize that effect when held by others. This deviates too far from the concept of "fair market value."

Section 2702 should be omitted entirely from the Proposal.

Debt Leases and Employment Agreements. One of the principal criticisms of current Section 2036(c) is its application to legitimate business transactions without an estate planning motive. The 1988 tax act attempted to mitigate the effect of the statute by allowing certain types of leases, employment agreements and debt which followed "cookie cutter" rules. Really

the 1988 act pointed out the conceptual flaws in Section 2036(c) by allowing certain "freezes," such as a 15 year note, and disallowing certain other "Freezes," such as a 16 year note, although the economics of both transactions were the same. This approach also intruded on every business transaction of a family owned business -- "freezing" business transactions. Although the notice accompanying the Proposal states that the replacement does not apply to employment agreements, any provision to include debt in the value of an entity also catches employment agreements indirectly as a liability of the entity. The Proposal also contains an attack on these legitimate business transactions which must be cleared away.

Application to Third Parties. In 1988 the deemed gift rules under current Section 2036(c) were changed so that the section would no longer apply if the donee of the gifted interest disposed of the stock to a non-family member. The Proposal changed so that the deemed gift rule would not apply in a similar situation.

In addition, Section 2703(a)(2) applies these special valuation rules in non-family situations if a gift would have occurred under ordinary valuation principles. This seems to require the use of artificial meretricious devices in non-family member situations to avoid the application of Chapter 14. Rather, Chapter 14 should not apply to unrelated parties, except that employees and other such unrelated parties ought to be able to avoid a gift by structuring their preferred stock freezes at the market testing rate.

Miscellaneous Issues. The Proposal is over broad in a number of other respects:

(1) It requires the valuation of the entity rather than just the valuation of the preferred stock. Under the current literal language of the Proposal, unlike Section 2036(c), it could apply to the gift of non-voting common and retention of voting common. It could jeopardize minority discounts by valuing the entity and determining the value of the common by a subtractive method despite the accompanying notice language.

(2) It applies to stock which is not "frozen" in value. The Proposal should apply only to stock which has no appreciation potential. In other words, stock which has a fixed or stated value on liquidation, conversion or redemption. In such a case the appreciation rights with respect to the frozen capital reside in someone else. That someone else also benefits from any failure to pay the dividends on the preferred. The proportionality rule under current Section 2036(c) precludes estate taxation where there is no mismatch of capital and appreciation rights. A similar concept must be developed under the replacement.

(3) It applies to publicly-traded securities where there is no valuation issue.

(4) It assigns a zero value to a wide variety of rights which are not discretionary. It also requires the assignment of value to retained voting rights -- a difficult valuation prospect.

(5) It applies to too many entities. The Proposal's 10% rule came from current Section 2036(c) where there is no sibling attribution. The threshold should be raised to 50% if sibling attribution continues to apply. In the way the Proposal will not apply where the entity is not subject to the family's control.

Problems Related to Fairness

80/20 Rule. The stated purpose of the Proposal is to ensure that 100% of the value of the business is taxed in the owner's estate.

The 80/20 rule seems designed to ensure that 120% of the business is taxed in the owner's estate. Consider the case of two parents who want to help a child buy a grocery store:

Investor Parent can loan the entire \$1,000,000 child needs at the current AFR. The Investor Parent's estate includes the \$1,000,000 note and the annual interest payments. However, Grocer Owner Parent cannot take back \$1,000,000 of preferred in the grocery store at the AFR. If he does, he has made a gift of \$200,000, and his preferred is still worth \$1,000,000 at his death. (A total of \$1,200,000, plus annual dividends). His alternatives (assuming he is properly advised) are to continue to share in 20% of the appreciation which is due to his child's efforts as to reduce his dividend payments.

In no case is Grocer Owner Parent able to bring his children in to the business on the same terms as Investor Parent. An unacceptable discrimination.

Inconsistent Application of the Valuation Rule. The Proposal is overly broad because the Treasury benefits from the adverse presumptions, but is not bound when taxpayers would benefit. For example, if a right is valued at zero, a gift results equal to the value of the right. If the right later appreciates in value, that appreciation is also taxed. Thus, the replacement, like current Section 2036(c), taxes the same property both for gift and estate tax purposes. It would be preferable to settle on a fair valuation rule which could apply in all circumstances, including a gift of specially valued preferred. The Proposal also should exempt the exercise or non-exercise of discretionary rights from the transfer tax system. It is possible that meretricious rights which are valued at zero for Chapter 14 could still result in gift tax annually under Chapter 12.

Application to Stock Not Held by Transferor or Spouse. The Proposal unfairly applies to preferred stock held by family members of the transferor. Current Section 2036(c) does not go so far as to apply to frozen interests held by someone other than the transferor or his or her spouse. One of the common uses of preferred stock in a family business is to give inactive children preferred stock and active children common stock. This provision gives that inactive children a veto over the gifts of common by the parents.

Liquidation Valuation. In family business with low cash flow such as a farm or real estate business, the IRS argues that the business should be valued at its liquidation value rather than its going concern value. Of course, this results in a higher value for the business. The Proposal mandates a cash flow or going concern approach for valuing the preferred stock. The IRS should not be permitted to value the business using a liquidation approach and then mandate the valuation of the preferred at cash flow value with its liquidation value is much higher. The method for valuing the business and the method for valuing the preferred must agree.

Hardship Exception. Although the Proposal goes a long way towards permitting flexibility by allowing a three year grace period for dividend payments and an insolvency exception, further relief is desirable. One improvement would be to allow relief when the earnings and profits or book income (adding back payments to family members) drops significantly from the adjusted earnings and profits on the date of the recapitalization. One concern has been that the business owner would set the dividend rate so high to avoid an initial gift that the rate itself would create hardship in paying future dividends. This objective computation would prevent this abuse as the drop in earnings would be separate from the dividend payments.

Prospective Application. The Proposal should apply prospectively only and generous transition period should be allowed for business owners and their advisers to adjust to these new rules.

Gift Tax Changes. The gift tax changes which target business transactions and allow unlimited gift tax exposure for business transactions were alternatives suggested in lieu of fixed valuation rules. As the Proposal contains fixed valuation rules, the proposed gift tax changes are unneeded. Moreover, further gift tax reporting requirements are unlikely to be productive. What is needed is a way to alert businessmen through the income tax return of the possible need to report transactions on a gift tax return. A further important change would be permitting business owners to waive the use of the unified credit (and to clarify existing law) so that gift tax returns can be audited and values finally determined. The present situation encourages game-playing by taxpayers and over-reaction by the IRS.

Problems Related to Complexity and Efficiency

In Effect Transfers. One of the discredited aspects of current Section 2036(c) is its notion of "in effect" transfers. The concept is mathematically impossible to apply. Section 2703(c)(2) proposes to extend this unworkable concept to all of the transfer tax. This section should be removed and Section 2701 of the Proposal rewritten so that a gift will result to the common shareholders if the value of property exchanged exceeds the special value of the preferred stock received.

Tax Elections. The Proposal generally requires timely elections. Many businessmen will assume that no gift is being made by applying ordinary valuation principles and will not make the required elections in a timely manner. The federal fisc will not be harmed by late elections as long as those elections are consistent with the taxpayer's prior actions.

Failure to Adopt Existing Tax Concepts. The Proposal would be simpler and easier to understand if it adopted other tax concepts, e.g. entities taxed under subchapters C or K (in lieu of partnership and corporation) and attribution rules from Section 318(a)(2).

In concluding this area, let me deal with one assumption which too often underlies much of the discussion surrounding potential repeal or reduction of 2036(c). That is the assumption that any legislative provision which somehow operates to reduce maximum revenue legislative provision which somehow operates to reduce maximum revenue production of a section of the tax code is a "loophole." Thus, legal permission of "estate freezes" is seen as a "giant loophole" simply because it permits the transmission of a family owned business from one generation to another without the imposition of confiscatory tax rates. The facts are that our entire tax code is designed to raise revenue and to fairly promote economic activity. There obviously is one certain remedy for a headache....decapitation; but except for 2036(c) our legislators have generally chosen to promote not discourage the growth and prosperity of some 20 million small, family-owned businesses in this nation. No wonder that the entire small business community, as represented by the Small Business Legislative Council and many other organizations, has fought this provision so fiercely. It is quite literally a battle for its life. Repeal of 2036(c) is not a loophole, rather it is a lifeline, to a vital sector of the American business community.

Finally, Mr. Chairman, this hearing record would be incomplete if we failed to address a directional guideline which governed the prior legislative process of Section 2036(c). It is expressed in a simple formula: Bad legislative process frequently produced bad legislation which in its own turn causes bad results. If you seek verification of this concept you need only examine the all too sad history surrounding Section 2036(c). —

First, it is important to recollect the process which characterized the enactment of 2036(c) as a provision in the Internal Revenue Code through the Omnibus Budget Reconciliation Act of 1987 and amended by the Technical and Miscellaneous Revenue Act of 1988. No Congressional hearings were ever held on any of the major public policy issues involved or to consider other possible, less intrusive positions. Similarly, no substantive floor debate was conducted in either the House or Senate. Congress chose not to "look before it leaped" and in the confusion which followed it produced a promise from the Internal Revenue Service that "clarifying" regulations would very shortly be issued by the Service removing much of the doubt and disturbance which had been caused. And yet again the process failed us. For months and months we waited while the IRS labored in secret to produce clarification and correction.

Finally, it just seemed to give up. On August 31, 1989, the IRS published its document. Unfortunately, in virtually every area, Section 2036(c) remains as vague, confusing and damaging to family owned business as before. In no way was the wait worth it. Mr. Chairman, to us, this entire process can only be characterized as a bad one.

As I have already illustrated in today's testimony, the legislation which was originally passed and subsequently "clarified" was also bad.

In closing I would wish to return to my opening theme. In terms of the fundamental tax policy expressed in Section 2036(c) the small business community is really confronted with two roads. The "old" road, the one we have been compelled to travel for more than two long years, can only be characterized as a critical progression. Poor process begat poor legislation, which in its own turn has produced disastrous real world consequences. The hearings here today can mark a significant step down another road. It is a road which thus far has seen sound process, in which all of the travellers have appeared constructive, open-minded and cooperative. Members of the Committee, I urge you to continue this journey with us. But in closing, may I offer one last caution. DO NOT DELAY! This is a trip which none of us, ranging from individual businessman to the entire national economy can afford to postpone. Detours, stop signs, delays should not, cannot be tolerated. Millions of family owned businesses throughout this nation demand constructive action, and they demand it NOW.



Members of the Small Business Legislative Council

Air Conditioning Contractors of America
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 Machinery Dealers National Association
 Manufacturers Agents National Association
 Manufacturers Representatives of America, Inc.
 Marketing Agents for Food Service Industry
 Mechanical Contractors Association of America, Inc.
 Menuswear Retailers of America
 NMTBA-The Association for Manufacturing Technology
 National Association for the Self-Employed
 National Association of Brick Distributors
 National Association of Catalog Showroom Merchandisers

National Association of Chemical Distributors
 National Association of Development Companies
 National Association of Home Builders
 National Association of Investment Companies
 National Association of Passenger Vessel Owners
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 National Association of Plumbing-Heating-Cooling Contractors
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 National Association of Small Business Investment Companies
 National Association of Surety Bond Producers
 National Association of the Remodeling Industry
 National Association of Truck Stop Operators
 National Association of Women Business Owners
 National Campground Owners Association
 National Candy Wholesalers Association
 National Chimney Sweep Guild
 National Coffee Service Association
 National Council for Industrial Innovation
 National Electrical Contractors Association
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 National Independent Dairy-Foods Association
 National Knitwear & Sportswear Association
 National Limousine Association
 National Lumber & Building Material Dealers Association
 National Moving and Storage Association
 National Office Products Association
 National Paperbox & Packaging Association
 National Parking Association
 National Precast Concrete Association
 National Shoe Retailers Association
 National Society of Public Accountants
 National Tire Dealers & Retreaders Association
 National Tooling and Machining Association
 National Tour Association
 National Venture Capital Association
 Opticians Association of America
 Organization for the Protection and Advancement of Small Telephone Companies
 Petroleum Marketers Association of America
 Printing Industries of America, Inc.
 Professional Plant Growers Association
 Retail Bakers of America
 SMC/Pennsylvania Small Business
 Small Business Council of America, Inc.
 Society of American Florists
 Specialty Advertising Association International
 United Bus Owners of America

STATEMENT OF SALLY NAREY, ACTING CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION, ACCOMPANIED BY DAN MASTROMARCO, ASSISTANT CHIEF COUNSEL FOR TAX POLICY, OFFICE OF ADVOCACY

Ms. NAREY. I am the Acting Chief Counsel for Advocacy of the Small Business Administration. I am appearing here today in that capacity, and my comments are those of the Chief Counsel for Advocacy, not necessarily those of the Administration.

I am accompanied by Dan Mastromarco, who is Assistant Chief Counsel for Tax Policy in the Office of Advocacy. As you are well aware, the Treasury Department is the chief spokesperson for the administration on tax policy matters.

I am, however, very pleased to appear before you to testify on the proposal to replace section 2036(c) of the Internal Revenue Code. Because my statement is quite lengthy and I know that there are many witnesses yet to follow, I will summarize it briefly for the committee, but would ask that the statement in its entirety be included in the hearing record.

I believe the case for replacement of 2036(c) is well-established. Perhaps more than any tax issue this legislative year, 2036(c) has commanded the attention of small business. Research data sponsored by the Board of Governors of the Federal Reserve, and the Small Business Administration indicates that about 57 percent of all partnerships and about 80 percent of all corporations in the market identifier file of 3.5 million firms are family-owned. For this reason, we think it is very important that action be taken.

The replacement proposal, as you know, represents the combined effort of a number of affected groups. These groups have worked together in good faith to design a mechanism which more narrowly targets abusive transactions, the original concern of 2036(c), while minimizing obstacles for intergenerational business standards. The replacement seeks to strike a balance between the needs of the enforcement community and those of the business community.

Let me make one observation on the process which has led us here today. I think you already heard this. It is very apparent to those who have provided input that there has been an exceptionally high level of cooperation between all affected interests.

While not everyone is expected to agree with the solution proposed, the participants in the process have understood the need to balance business and enforcement concerns and seek a solution to this issue.

I commend you, Mr. Chairman, the committee, the Department of the Treasury and the private sector representatives, for working to fashion a less onerous replacement proposal for 2036(c). It is our hope that the conciliatory process which characterized the development of this replacement proposal is instructive of future tax policy debates.

As you know, 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987, and was broadened by the Miscellaneous Revenue Act of 1988. Its original purpose was to prevent abusive circumvention of estate and gift taxes through estate freezes. Many common estate planning devices are now subject to 2036(c).

Under 2036(c), in a recapitalization, for example, the value of the appreciation after the transfer of common stock would be brought back into the decedent's estate regardless of the children's efforts to generate the appreciation. The tax benefits of stock recapitalizations and other estate freezes were significant since appreciation of the business might have been taxed at a rate of as high as 60 percent, when one includes State income. Preferred stock provides retirement security, parents could retain legal control through voting rights, and the children were given an incentive to generate appreciation, and estate taxes were determined in advance.

There was nothing illegal about these transactions. There was, however, some concern that many such transactions were often abusive in other than arm's-length contexts, because the value of the gifted or retained interest—if set too low—could avoid notice until a significant time after the transaction took place. The potential for abuse also existed because of the subsequent action or inaction of the transfer or with respect to the retained interest.

Section 2036(c) was designed to close estate freeze loopholes. By broadly drafting the language of 2036(c), Congress sought to cover various types of abusive estate freezes.

No one disagrees that abusive tax avoidance schemes should be stopped. Proponents of 2036(c) argue that the law is necessary to do so. Nevertheless, the small business community and many tax experts agree that Congress went too far to curb abuses.

There are three immediate problems with the law. First, the provision is unclear in its application. Second, where it is clear, it is overreaching. Although practitioners differ over exactly which transaction will be under the purview, they agree that it will cover non-abusive family transactions never intended to fall within the scope. Third, the provision offers an estate tax solution to a gift tax problem. In doing so, it disregards the efforts that the recipients of future appreciation of businesses have made in billing that appreciation.

The small business community was first to recognize a serious problem and unintended consequences of 2036(c), and brought these problems to the attention of the SBA, the Department of the Treasury and the Congress.

As indicated, the discussion draft will be analyzed fully by the Treasury Department, which is the principal spokesman for the Administration on tax policy matters. I would, however, like to briefly outline what the Office of Advocacy views as ways in which the proposal could be improved.

First, let me say that the discussion draft has many advantages over 2036(c). Most importantly, the proposal recognizes legitimacy of transfer of future appreciation, something 2036(c) did not do. And it does not eliminate the use of stock recapitalizations. To the extent that the value of the common stock can grow at a rate exceeding that paid out in qualified fixed payments, appreciation may be removed from the estate without gift or estate tax consequences. The proposal also recognizes that the problem that gave rise to 2036(c) was one of valuation. Also, this proposal advances a gift tax solution to a gift tax problem. The proposal would permit the favorable assumption as applied to qualified fixed payments that the payments will be made and made in perpetuity.

However, while the proposal before us represents significant progress in addressing the problems posed by 2036(c), there are several areas where we believe it could be improved.

First, the proposal is overly broad and should instead be limited to circumstances which IRS compliance data indicate is a problem. There is insufficient evidence that major abuses exist in the utilization of agreements. These agreements are common among small businesses and allow families to fix the value of transferred interest at an early stage and plan in advance for the imposition of estate taxes.

Second, the proposal does not give sufficient leeway to avoid the payment of a qualified fixed payment, raising competitiveness and equity concerns.

Third, the proposal assumes the value of the option for future appreciation is always worth at least 20 percent of the value of the company when this may not be true.

Fourth and finally, the proposal fails to define the parameters of an acceptable market testing rate. If it is set too high or is inflexible, it will be punitive and inequitable.

Mr. Chairman, I greatly appreciate the opportunity to appear before you today and discuss this important issue. I commend the committee and the Department of the Treasury for working together with the affected business groups to seek an alternative to 2036(c). The replacement proposal is a step in the right direction, not only because of certain substantive changes that it proposes, but also because of the process through which it evolved.

I am hopeful that the spirit of cooperation shown here will be reflected in the final legislation and in the process of developing solutions to other potentially divisive issues.

Thank you.

Chairman ROSTENKOWSKI. Thank you.

[The statement of Ms. Narey follows:]

TESTIMONY OF
HONORABLE SALLY NAREY
ACTING CHIEF COUNSEL FOR ADVOCACY
U.S. SMALL BUSINESS ADMINISTRATION

Dear Mr. Chairman and Members of the Ways and Means Committee:

I am pleased to appear before you as the Acting Chief Counsel for Advocacy, U.S. Small Business Administration, to testify on your proposal to replace Section 2036(c) of the Internal Revenue Code.

As you know, the Treasury Department is the primary spokesman for the Administration on tax issues. These views are those of the Chief Counsel for Advocacy and do not necessarily reflect those of the Administration.

I believe the case for replacement of Section 2036(c) is well established. Perhaps more than any other tax issue this legislative year, Section 2036(c) has appropriately commanded the attention of small business. Originally of concern only to estate planners, the effect of Section 2036(c) on the transfer of business interests is now felt and understood at the grass roots level. Unlike many transactional code provisions, Section 2036(c) may apply to a business owner once in a lifetime, but its detrimental impact is so severe that it interferes with what many business owners consider a fundamental right: the transfer of their business to their children.

Section 2036(c) makes the estate and gift tax laws inequitable and unworkable in the family business context. In addition to achieving its objective of quashing the possibility of estate planning abuses, Section 2036(c) prohibits common transactions for transferring business assets, favors families whose wealth is represented by marketable securities over those who own small businesses and farms, discourages childrens' involvement in family businesses, and dramatically increases the costs and uncertainty of transferring ownership. Sound tax policy should at least be benign as applied to family-owned businesses; it should never encourage the break-up or sale of those businesses.

The structure of this replacement proposal, as you know, represents the combined effort of a number of affected groups. These groups have worked in good faith to design a mechanism which more narrowly targets abusive transactions -- the original concern of Section 2036(c) -- while minimizing obstacles for intergenerational business transfers. The replacement proposal seeks to strike a balance between needs of the enforcement community in preserving the integrity of the transfer tax system with that of the business community in developing an acceptable mechanism for business transfers.

I believe your proposal makes a good start at achieving this balance by recognizing the legitimacy of transferring future appreciation, and by seeking a gift tax solution -- not an estate tax solution -- to a gift tax valuation problem. My testimony will discuss the difficulty family-owned small businesses face with Section 2036(c), the positive attributes of your Committee's replacement proposal, and some of the problems which still remain with the proposal.

Before discussing specific aspects of the proposal before us, however, I would like to make one observation on the process which has led us here today. It is apparent to those who have provided input in developing this proposal that there has been an exceptionally high level of cooperation between affected interests. The process by which this proposal was developed is easily distinguished from process by which Section 2036(c) was originally developed, without hearings and without adequate opportunity for public debate. In the absence of meaningful opportunity for debate, the business community often finds itself before this Committee, seeking change in laws which had unforeseen or underestimated effects on business planning. And this Committee must then work towards modification or repeal, with the attendant time and budgetary considerations, after initial damage is done.

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While not all are expected to agree with the solution proposed today, the participants in this process have understood the need to balance business and enforcement concerns and seek a consensus solution to a difficult and highly technical issue. I commend this committee, the Department of Treasury and the private sector participants for working to fashion a less onerous replacement proposal for Section 2036(c). It is my hope that the conciliatory process which characterized the development of this replacement proposal is instructive of future policy debates: not only when the business community threatens repeal of an unworkable law, but when the tax-writing committees and their staff first set out to fashion that law.

I. The Anti-Freeze Rule of I.R.C. 2036(c)

Section 2036(c) was enacted as section 10402(a) of the Omnibus Budget Reconciliation Act of 1987 and was broadened by section 3031 of the Miscellaneous Revenue Act of 1988. Its intent was to prevent circumvention of the estate and gift taxes through the misvaluation of assets.

Technically, Section 2036(c) applies if a business owner "in effect" transfers an interest having a disproportionately large share of the potential appreciation in the business while retaining an interest in the income or rights of the enterprise. Section 2036(c) then serves to pull the value of the appreciated interest back into the estate, potentially many years after the rights to future appreciation were transferred. If the transferor continues to hold the retained interest until death, the value of the transferred property will be included in the transferor's estate. If the transferor's retained interest terminates or if the transferred property is disposed of outside the transferor's family, the value of the transferred property will be treated as a deemed gift. The effect of Section 2036(c), in either case, is to tax the post-transfer appreciation from the time of such transfer to the time of the terminating event.

In general, in order for Section 2036(c) to apply four conditions must be met. An individual must: (1) own, directly or indirectly, at least 10 percent of the voting power or income stream in an enterprise; (2) effectively transfer a disproportionately large share of appreciation in the enterprise to someone else; (3) retain disproportionately large share of the income of, or rights in, the enterprise; and, (4) own the retained interest at death or transfer that interest within three years of death.

In an attempt to stop valuation abuses, many common estate planning devices, such as stock recapitalizations, were the target of 2036(c). In a typical stock recapitalization, a portion of the parent's common stock was converted into preferred and the remaining common stock was given or sold to the children. The common stock, which was given or sold to the children, was assigned all future appreciation in the business; the preferred was assigned fixed liquidation and dividend rights. If the transaction were properly executed, upon the parent's death, the preferred stock would be redeemed for liquidation value, the children would obtain control and appreciation would be received without tax consequence. Under 2036(c), however, the value of the appreciation after the transfer will be taxed as part of the decedent's estate, regardless of the efforts of the children in generating that appreciation.

Stock recapitalizations and other "estate freezes" had favorable tax implications, since they allowed appreciation of the business after the recapitalization to avoid tax imposed at a rate as high as 60 percent. "Freezes" also were popular because preferred stock provided retirement security, the parents retained legal

control through voting rights, children were given an incentive of appreciation attributable to their efforts, and estate taxes were determinable in advance.

There was nothing illegal about these transactions. The Unified Transfer Tax Act, and subsequent case law had long permitted shifts in future appreciation. The straightforward device offered businesses a legitimate tool for estate planning. However, there was a perception that many transactions were often abusive in other than arms-length contexts because the gifted or retained interest, if improperly valued, could evade notice until a significant time after the transaction took place. More specifically, limited preferences, discretionary rights and other "bells and whistles" could be utilized to undervalue property for transfer tax purposes. The potential for "abuse" also existed because discretionary action or inaction by the transferor with respect to the retained interest might shift wealth without estate or gift tax consequence. For example, the failure to issue dividends on noncumulative stock would enhance the value of the corporation -- its future appreciation.

Enacted in 1987 and expanded in 1988, Section 2036(c) was the new weapon devised to close these "loopholes." By broadly drafting Section 2036(c), Congress sought to cover various types of "abusive" estate freezes. It resulted, however, in a provision that targeted freezes, rather than the underlying problem of misvaluation.

II. Section 2036(c) Has Devastating Effects on Business Estate Planning

Section 2036(c) is a poor solution to an unquantified abuse. The immediate problems with the provision are three-fold. First, the provision is still unclear in its application. The provision might apply; for example, when a business interest is exchanged for a promise to pay a fixed purchase price. Almost any family transaction in which one member gives or sells to another an equity interest in business, retaining the right to receive fixed dollar amounts or disproportionate voting rights may be affected. IRS Notice 89-99 does provide guidance with respect to selected issues arising under Section 2036(c), but it is not dispositive of the many issues surrounding this complex law.

Second, where the law is clear, it is clearly overreaching. Although practitioners differ over the exact transaction that will fall under its purview, all agree that it will encompass many legitimate, non-abusive family transactions never intended to fall within its scope. The provision attaches to almost all transfers of future appreciation in family-run businesses, effectively endangering, if not prohibiting, common sense methods for transferring business ownership. In its efforts to end abusive avoidance devices involving the undervaluation of transferred interests or the manipulation of discretionary rights, it elevates tax administration over sound business planning considerations.

Third, the provision is inequitable because it offers an estate tax solution to a gift tax problem. It disregards the considerable efforts that the recipients of future appreciation in the business have made in achieving that appreciation. Irrespective of their efforts, 2036(c) pulls the gift that bears their handwork determination and judgment back into the estate of the previous owner. This estate tax solution can yield highly punitive results. A \$50,000 gift can result in the inclusion of \$1 million, or in the alternative a \$1 million gift can result in the inclusion of \$50,000. The inclusion should also apply to tax an estate which at the time of the transfer was below the \$600,000 exemption level.

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How this might operate in application to a family business is easy to imagine. Assume, for example, that an owner of a manufacturing company has struggled for many years to develop that business into a moderately successful enterprise of 15 employees, many of some of whom have spent the better part of their lives with the company. During development of the business there were the usual ups and downs, the competition was fierce, but the business eventually assumed an established position in the marketplace. Indeed, part of the profits of the business went to pay for the education of the owner's two daughters, one of whom received an MBA.

After many years, the owner reached an age where he wished to pass on the business to the daughters who had learned the business from the ground up. Although he trusted in his daughters' abilities, rather than give his entire interest to them outright he chose to relinquish control by keeping an interest in preferred stock and giving to them future appreciation in the value of the business. Voting control would be relinquished over a period of time.

The father lived to a ripe old age and retired in a warm southern climate. In the ensuing years, the daughters, with their combined business acumen and drive, were able to turn the business into a larger successful company, with several manufacturing plants. The business, which at the time of the gift grossed \$1 million annually, grossed \$14 million annually at the time of the father's death. Its assets had increased from \$500,000 to \$7.5 million and it had reached a total value of \$26 million, appreciating from the time of the gift by \$23 million. Despite the efforts of the daughters in increasing the value of the company 9 times, the entire appreciation will be attributable to the father, brought back into his estate and subject to tax at a rate exceeding 50 percent.

In order to pay the taxes, the daughters were presented with an ultimatum: spin off some operations and reduce the workforce at the home plant or sell the business to pay the taxes. Rather than split the business and start anew, the daughters elected to sell the business to the highest bidder, which happened to be a foreign investor. While the transactions, fact patterns and industries will differ, a version of this scenario will be reenacted over the next decade as Section 2036(c) applies to more and more estates.

The exact impact of the provision on businesses is difficult to determine from existing data sources. In order to measure the number of businesses affected by the provision in a given year, for example, we would need to know at a minimum: (1) the number of businesses with more than \$600,000 in assets; (2) that are family run; and (3) that are intended to be passed along to family members. A look at the number of businesses likely to be affected by the estate-taxes, and the number of family-owned businesses helps us to understand the impact of Section 2036(c). And what we do know suggests that the potential effects of the provisions are substantial.

First, we know that there were about 283,000 partnerships and 133,000 non-farm sole-proprietorships in 1986 with greater than \$500,000 in assets. Additionally, there were about 302,000 corporations with greater than \$1 million in assets in 1986. Hence, as of 1986 there were, as a rough approximation, 718,000 businesses with assets substantial enough to be subjected to estate taxes. The number of businesses within these asset classes are expected to be greater today, given normal growth assumptions and the failure of current law to index an exemption for estate taxes. Moreover, because the estate tax laws apply to the devolution of all wealth, the personal assets of a business

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owner must be combined with the business assets to determine if the estate tax threshold is exceeded.

Second, recent data derived from the National Survey of Small Business Finances, sponsored by the Board of Governors of the Federal Reserve and the Small Business Administration, indicates that about 57 percent of all partnerships and about 80 percent of all corporations in the Dun's Market Identifier file of 3.5 million firms are family-owned. Applying these percentages to the approximations of affected corporations and partnerships, we estimate that 164,000 partnerships and 242,000 corporations are potentially affected by Section 2036(c) and by the replacement proposal.

IV. The Scope and Operation of the Replacement Proposal

The current proposal will be analyzed fully by the Treasury Department, which is the principal spokesman for the Administration on Tax Policy matters. However, I would like to briefly outline the scope of the proposal from the small business perspective.

In sum, the proposal is broad, encompassing trust and buy-sell agreements, in addition to recapitalizations. The basic purpose of the proposal is to require all value to be run through the transfer tax system, by the application of either gift or estate taxes. To accomplish this, the proposal creates a system for immediately valuing the amount of a gift, and for ensuring that the assumptions leading to the valuation of that gift are adhered to throughout the transferor's life. The operation of the proposal as applied to recapitalizations, Grantor Retained Income Trusts and typical freezes encompassed by Section 2036(c) can best be understood when broken down into three levels:

(1) determination of the gift at the time of the original transaction; (2) determination of estate or gift tax treatment during the firm's existence; and (3) reconciliation of the interests at death.

At the outset of the transaction, the amount of the gift, the residual interest, is valued as the difference between the retained interest and the value of the business. In determining the value of the retained interest, voting rights or rights in the same or junior class of stock will be considered; however, all discretionary rights will be assigned a zero value. Only the value of the income stream to "qualified fixed payments" (QFPs) will be considered to have positive value if the retained interest has preference rights over any rights under the transferred interest. QFPs in a partnership or corporate context would include payments or distributions fixed as to time and amount, such as cumulative dividends. In the case of trusts, QFPs are a fixed amounts payable at least annually and which are either a fixed percentage of the trusts assets or a noncontingent remainder interest if all other interests in the trusts are QFPs.

All discretionary rights retained by the transferor, therefore, will be assumed to be worthless under the proposal, and will not enhance the value of the retained interest. The purpose of this rule is to ensure that the value of these rights is included in the estate or treated as a deemed gift, i.e. that they do not escape tax consequence.

The proposal would permit the business to fix the QFP rate of return. Allowing the firm to fix the rate of return is not considered to be abusive because the assignment of a low rate of

¹ These figures are derived from the 1986 IRS Statistics of Income.

return on the retained interest will reduce the value of the retained interest and increase the value of the transferred interest, with greater gift tax consequences. Alternatively, the assignment of a high rate of return on preferred will cause the value of the preferred to be greater than the gift, with greater estate tax consequences.

Assuming there is no fixed period of redemption, the QFP income stream will be valued as if were payable in perpetuity. The value of the residual interest will be the relative value of the firm which the rate of the qualified fixed payment bears to a benchmark rate. The benchmark rate, which is not established in the proposal, is supposed to approximate the opportunity cost of the residual interest, i.e. what that interest would fetch in the open market for a similar investment. However, the lower this rate is set, the more possible it is to maximize the transfer of the future appreciation. For example, if a condition of the transfer of future appreciation by the transferor was that the transferor would receive a 5 percent cumulative dividend, and the benchmark rate were 10 percent, the transferor has gifted an interest equivalent to 50 percent of the value of the firm. In no event can the transferred value be less than 20 percent of the sum of the total equity in the corporation or partnership, and any debt which the corporation or partnership owed to the transferor or members of the transferor's family. This is meant to establish the minimum "option value," reflecting the right to future appreciation.

The second level of the proposal ensures that the firm or the trust actually pays out the QFP at the assumed rate. The approach will permit a partnership or corporation to pass (not to pay) QFPs for three years after the due date, as long as the firm makes those payments up. If the firm fails to make the payment upon the expiration of three years, the transferor will be treated as making a gift of the unpaid QFP, unless the instrument provides that the missed payment will bear compound interest at the assumed discount rate or unless the firm is insolvent or bankrupt. A trust will have 65 days from the end of the trust year to make the QFP.

At the third level, the proposal provides rules for reconciling the value of the interests upon disposition to a third party. If the rights that were previously valued at zero are later transferred, the value of the later transfer will be reduced by the amount by which the original gift was increased. In the case of dispositions of the rights to receive QFPs for greater value than assumed under the special valuation method, the excess will be treated as a gift.

The proposal would provide special, harsher rules in the case of buy-sell agreements. For buy-sell agreements the option price would have to be determined under a formula which had been reviewed within three years of the exercise of the option. Moreover, the value of property subject to other options, rights of first refusal and leasehold rights held by family members would be determined without to such options of rights.

V. Positive Attributes of the Replacement Proposal

The discussion draft before this Committee has many advantages over Section 2036(c). Perhaps most importantly, the proposal recognizes the legitimacy of transfers of future appreciation; it does not eliminate the use of recapitalizations. To the extent the value of the common stock can grow at a rate exceeding that paid out in QFPs, appreciation will be removed from the estate without estate or gift tax consequence. The proposal also correctly recognizes that the perceived problem which gave rise to Section 2036(c) was one of valuation. In the effort to solve

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that valuation problem, the proposal advances a gift tax solution to a gift tax problem -- not an estate tax solution. Assuming some guidance is forthcoming on the market testing rate, it would be possible under the proposal to determine gift tax liability the moment a recapitalization or other transaction effecting a traditional "freeze" is consummated.

Additionally, the proposal would permit the favorable assumption, as applied to QFPs, that such payments will be made, and made in perpetuity. This will serve to increase the value of the retained interest and decrease any gift tax liability. The proposal also provides some leniency for a business which is having difficulty meeting the QFPs: it permits a grace period of three years in which to pay out the cumulative dividend and forgives businesses in insolvency or bankruptcy from payment of the QFP.

Finally, the proposal makes some further strides towards equity by not imposing a trade or business requirement. In other words, the proposal does not appear to target family-owned businesses over the transfer of other forms of wealth in the family contexts. The proposal will apply to trusts, partnerships and corporations.

VI. Remaining Problems with the Current Proposal

Despite the advantages over current law there remain several problems with the current proposal from the small business perspective.

First, the proposal is overly broad. The IRS has not made clear from disclosed Taxpayer Compliance Measurement Data or other audit indicia exactly what types of transactions have afforded the greatest abuses, whether these transactions involved personal assets or business, and the extent of the abuses. Nevertheless, the proposal assumes that a significant and growing problem exists in the business context; and that this problem extends to buy-sell agreements as well as traditional recapitalizations. The proposal should be limited to those devices which IRS compliance data affirmatively indicate is the crux of the problem.

The use of buy-sell agreements as an estate planning device, is common among small businesses; not because they are necessarily motivated by tax avoidance, but because they allowed families to fix the value of transferred interests at an early stage, and plan in advance for the imposition of estate taxes. Insufficient evidence has established that substantial abuses exist in the utilization of buy-sell agreements which would not be attackable under pre-Section 2036(c) law.

The proposal should not propose a separate valuation system for buy-sell agreements. The proposal should merely provide that buy-sell agreements are one factor which may be taken into consideration to establish value, but are not conclusive as to value. This approach would be consistent with the existing regulations. The proposal should also not extend to joint purchases.

Second, a firm is not given sufficient leeway to avoid the payment of a dividend in cases where no increase in the value of the residual interests results. The three exceptions provided under the deemed gift rule: first, for firms in bankruptcy or insolvency; second, for firms which pay the dividend within three years of the due date; and third, for firms which provide that the dividend be compounded, is an attempt to address the problem, but is not a solution. The proposal still fails to provide an adequate safeguard for firms which may have reasons other than

insolvency, bankruptcy or tax avoidance for passing on the QFP.

The arbitrary payment rule is problematic in several respects. The application of the deemed dividend rule in the replacement proposal assumes that the failure to pay a "QFP" automatically results in the transfer of equivalent value to the residual interest, when this assumption may not hold true. For publicly traded securities, cash or other liquid assets placed in trust, a mandatory payment rule may not present great problems. However, downturns in the global, national or regional economy, downturns in the industry, increased costs of doing business, a lawsuit, or even the loss of a significant customer can cause firms to have difficulty adhering to their assumed dividend rate, even where no increase in the value of the residual interest results. The proposal offers a much too scientific solution for an unpredictable market.

And the problem is not just a question of equity; it is a question of efficiency. Requiring a firm to make a payment or incur a gift tax may elevate tax consideration over business planning, since a firm may need working capital to meet competition or to grow into new markets.

A mechanism could be developed which would allow limited exceptions from the arbitrary rule, without jeopardizing the integrity of the proposal. The approach might contemplate a mechanism whereby a firm can pass upon a QFP for valid business reasons, as it might do in an arms-length transaction. One possible solution would be to transfer the burden of proof to the firm in cases where a QFP was not made to demonstrate that a deemed gift has not occurred.

Another possibility would be to permit the firm to pass on a QFP if insufficient profit would enable the payment of a dividend. The U.S. Chamber of Commerce, for example, generally proposes that the deemed gift rule be inapplicable if the sum of the entity's earnings and profits plus compensation paid to family members is less than the QFP. It should be noted in connection with the Chamber's suggestion that a related solution might permit the income stream of a QFP to be determined by specific reference to the sales, profit, production or output of a business, so long as the payment is nondiscretionary.

We appreciate the administrative difficulty the Service anticipates in enforcing a broad exception to the deemed gift rule. Similar problems exist in the context of determining appropriate executive compensation levels in a closely held company. Moreover, we recognize that the concept of a QFP is integral to the proposal since it is the means by which the proposal ensures that the initial payout assumptions that determined the gift amount are followed. Nevertheless, we believe that the inequities and inefficiencies that would result from an arbitrary rule justify further efforts towards an escape mechanism. If such a mechanism is too complex to fashion, the proposal is flawed.

Third, the proposal assumes an arbitrary value of the option for future appreciation -- the value of the residual interest -- at 20 percent. This 20 percent floor reflects the assumption that the option to receive future appreciation in a company is always worth at least 20 percent of the value of the company. There are at least two problems with this assumption: (1) it ensures that a firm will gain no benefit from approximating the market testing rate as closely as possible; (2) it sets an arbitrarily high price for the option value.

As noted in an earlier section, the determination of the relevant percentage share of the residual interest is determined by permitting a firm to fix a rate of return for QFPs and by

assuming that QFPs will be paid in perpetuity. Under this approach, the ratio of the value of the retained interest to the transferred interest will reflect the QFP bears to the market testing rate. If the yet-to-be-determined testing market rate is 10 percent, a QFP set at 7 percent will cause the transferred interest to be valued at 30 percent of the total equity value of the firm. A lower QFP rate will increase the value of the retained interest will be less, but decrease the value of the gift.

The establishment of a minimum optional value is inconsistent with the theoretical basis of the proposal: that no gift occurs if the return on the retained interest reflects the market rate of return. The purpose in setting this ratio is to reflect the opportunity cost of the slower income stream when compared with a reasonable market rate of return. The closer the firm gets to the market testing rate, the closer the transaction reflects a non-arm's length transaction; something which ought to be encouraged. However, under the 20 percent arbitrary rule, a firm will gain no benefit from setting the QFP any closer than 80 percent of the market testing rate. The 80:20 floor simply penalizes firms that come closer to four-fifths of the benchmark rate. Moreover, the arbitrary floor for firms with high earnings and low appreciation rates will be set too high. This is the converse of the problem experienced by firms with low asset to earnings ratios which must approximate the market testing rate to avoid the imposition of immediate and heavy gift taxes.

The option should not be assigned an arbitrary floor value, or in the very least the floor should be lowered to 10 percent. Reducing the assumption of the arbitrary value of the residual interest from 20 percent to 10 percent will not solve the theoretical inconsistency; however, it will reduce the practical problem.

Fourth, the proposal fails to define the parameters of an acceptable market testing rate, which, if set too high, or if inflexible would be punitive for some small firms. I believe that some attempt must be made to define an acceptable market and flexible testing rate, which should not be left to regulations.

As long as no guidance is provided on an appropriate market rate, the proposal presents a structure for a solution, but no solution. The rate which is assumed to be the testing rate can regulate the ability of a firm to use QFPs and transfer future appreciation.

Furthermore, imposing an inflexible, external benchmark rate can lead to serious inequities. The degree of inequity will depend directly upon the differential between the firm's assumptions of an acceptable QFP rate and the market testing rate. Under the proposal, the amount of the gift determined at the time of the initial transaction will be based on the relative ratio of the assumed pay out rate to some benchmark rates: the larger the differential between the two, the greater the immediate gift. If the potential pay-out of earnings is low, the gift will be high, irrespective of the ability of the firm to approximate the benchmark rate or of the firm's liquidity at the time of the transaction. Indeed, firms least likely to pay-out a high QFP rate (and therefore more likely to be subject to an immediate gift tax) will be doubly disadvantaged: they will be the firms most illiquid and least able to survive a heavy gift tax.

Many external factors can influence the firm's ability to pay QFPs at a specified rate. These factors, as noted, include global, national, and regional economic conditions, and the firm's individual health. Additionally, the earnings rate will be influenced by the size of a firm, the location of a firm, or the particular industry involved. For small businesses who

happen to be in industries or regions with low earnings to asset ratios, the value of the business may increase at a faster rate than earnings relative to other industries.

Indeed, our data suggests substantial fluctuations in earnings rates across firm sizes and industries. For example, by taking certain industries at random, we determined that according to the 1984 Statistics of Income, manufactures of food and kindred products and fabricated metal products averaged a return on equity of approximately 10 percent. This differed from other industries such as the manufacture of electrical and electronic equipment, which averaged a return on equity of 12 percent. Within the electrical and electronic equipment manufacturers industry, wide discrepancies exist across firm sizes. Firms with between \$500,000 and \$1 million in assets indicated a return on equity of negative 4 percent, whereas firms with between \$25 million and \$50 million in assets posted a return of 21 percent on equity. Lesser fluctuations can be seen in the data on food and kindred products, where a firm with between \$500,000 and \$1 million in assets had a return on equity of less than 2 percent while firms with \$50 million to \$100 million had a return of 14 percent. These fluctuations in earnings rates are merely illustrative of those found across firm sizes and industries.²

Owners of small businesses with low earnings to asset ratios who wish to pass their business along to the second generation will be faced with an ultimatum: (1) pay an immediate gift tax which represents a significant portion of the estate; or (2) pay a dividend at a rate above which sound business planning would dictate. Payment of the dividend at a higher rate will, as previously alluded to, deter from the firm's ability to expand and to compete.

The Committee should define the parameters of an acceptable market testing rate in a flexible manner, and should establish those rates at the lowest acceptable levels given revenue considerations. One possibility, would be to publish a table of acceptable rates on a yearly basis, that would differ by broad industry classifications. In any event, market rates should be discounted due to the nondeductibility of the payments at the firm level.

In establishing these rates, the Committee should utilize additional revenue that is expected to be gained from the adoption of the structure proposed in the discussion draft. In all likelihood, QFPs will substitute avoidance of transfer taxes for the incursion of income taxes. The payment of QFPs will have immediate tax consequence in the form of income taxes to the recipient, and they will not be deductible at the firm level. Also gift tax revenue will likely increase due to the annual gift tax treatment of passed dividends and the discounting of the preferred stock. Income tax effects, as well as the estate and gift tax effects, should be taken into consideration in determining the revenue effects of this proposal.

Fifth, the proposal is overly complex. As this Committee knows, concerns for simplicity often guide tax policy debates, but ultimately are relegated to a minor role when compared with the revenue considerations or the policy to be effected, especially when legislation is driven by efforts to stop suspected abuses. Contributing to this recurring problem is the generally accepted notion that simplicity is inherently at odds with fairness: what

² These fluctuations are indeed recognized by IRS Rulings as a reasonable basis for determining differing valuations of business based on cash flow. See, Revenue Ruling 68-609, 1968-2 CB; Revenue Ruling 59-60.

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is fair must be complex. For small business, however, simplicity often translates directly into fairness.

Assuming that the appropriate solution to this problem is to make the gift and estate tax laws apply fully to the devolution of family business property, a certain amount of complexity is unavoidable. A difficult consideration in the development of this proposal has been the assumption that the family context involves non-arms-length transactions which may provide greater opportunity for abuse than other contexts. The family transaction, therefore, is more heavily scrutinized from an enforcement perspective.

The replacement proposal can make necessary strides towards simplification in several ways. As indicated earlier, the proposal is too broad, and should be narrowed by excluding joint purchases and buy-sell arrangements. If the Committee wants to address joint purchases or buy-sells, it should do so in a separate proposal. Also Section 2703(c)(2) continues the "in effect transfer" concept of Section 2036(c) and enlarges its scope. The meaning of this clause is unclear and will generate much case law. Last, the proposal creates new family attribution rules. These attribution rules are different from that specified in Sections 318 and 267 and other areas of the Internal Revenue Code. The proposal could be simplified if the attribution rules of Section 318 are applicable.

VII. Conclusion

The grass roots efforts to repeal 2036(c) by the business community have not been grounded in a desire to merely resurrect a tax avoidance device. The issues before this Committee are more fundamental than that, and go to the heart of tax policy debate over the imposition of estate taxes on business assets. A broad question -- not directly addressed here today -- underlies the business community's concern over Section 2036(c): Do the estate and gift tax laws operate appropriately in the business context?

As this Committee and the Senate Finance and Small Business Committees have heard, Section 2036(c) has had an unjustifiably negative impact on the transfer of family-owned businesses. In its efforts to encompass almost every possible abuse in estate planning, Section 2036(c) has resulted in a provision which is inequitable and is inconsistent with the policy rationale underlying the estate and gift tax system.

The question over the proposed structure of the replacement provision to Section 2036(c) should appropriately be divorced from the more philosophical question concerning the accumulation of family wealth. The principal justification of estate and gift taxes is not to raise revenue, but to place limitations on the concentration of wealth upon the taxable event that separates that wealth from its owner. The effect of imposing estate taxes on active trade or business property, however, is inherently different from the effect of imposing such taxes on personal assets. Unlike taxing the devolution of wealth in the form of collectibles, publicly traded securities or cash, the taxation of a businesses can affect the ongoing concern of the business; it can reduce the good will of a business that has long been generated; and, it can dismantle a successful economic unit that has succeeded in innovating, generating jobs and last but not least -- paying taxes.

Despite important policy distinctions between personal and business assets, greater latitude is currently provided under the estate and gift tax laws for the transfer of personal use

property. Section 2036(c) specifically attacks business as opposed to personal wealth, illiquid as opposed to liquid assets and families as opposed to unrelated parties. It encourages business owners to sell to outsiders, rather than to family members, whenever sales of their interests are contemplated. Moreover, it is inequitable within the family context: it favors families whose wealth is represented by passive securities over those whose personal efforts had created the wealth in the form of an active business; and, it unfairly permits the parent who can give cash to a child to buy a business without adverse tax consequence.

In the balance, the suspected revenue lost through abusive estate freezes is not worth the known damage to family business that Section 2036(c) will cause. The amount forgone through estate freezes is a small portion of the amount taken in from estate and gift taxes and an extremely small portion of the total tax dollars generated from all sources.³

Section 2036(c) should be seen for what it was intended to be: a device to assist the IRS in correcting valuation abuses in recapitalizations. It should not seek to accomplish this objective by prohibiting common sense transactions in estate planning; or, by invoking a legislative panacea to enforcement concerns. It should limit itself to valuation questions, without interfering with business or family planning. If the transfer tax system is careful not to encourage the sale or break-up of family businesses, it must inevitably allow some build-up of future appreciation to pass unencumbered to the offspring.

Again, Mr. Chairman, I greatly appreciate the opportunity to appear before you today and discuss this important issue. I commend this Committee and the Department of Treasury for working together with the business groups to seek an alternative to Section 2036(c). The replacement proposal is a step in the right direction, not only because of certain substantive changes it proposes, but because of the process through which those changes were developed. I am hopeful that the spirit of cooperation shown here will be reflected in the final legislation and in the process of developing solutions to other potentially divisive issues.

³ According to the 1989 Commissioner's Annual Report, the total revenue generated from estate and gift taxes constitutes less than 1 percent of the total revenues collected in the U.S. For fiscal year 1989, some \$8.144 billion were collected from estate taxes and \$829 million from gift taxes, as compared with \$1.013 trillion from all sources. Furthermore, according to the IRS, the net worth of estates with more than \$500,000 contains much more than family business assets: Out of the gross estate of \$36 billion, \$8.4 billion was in real estate, \$1.5 billion in notes and mortgages, \$3.4 billion in bonds, \$3.8 billion in cash, \$1.7 billion in household goods and other assets, \$9.9 billion in stock (publicly traded and private) and \$1.7 billion in noncorporate assets.

Chairman ROSTENKOWSKI. Mr. Apolinsky.

STATEMENT OF HAROLD I. APOLINSKY, VICE PRESIDENT-LEGISLATION, SMALL BUSINESS COUNCIL OF AMERICA; AND PARTNER, SIROTE & PERMUTT, BIRMINGHAM, AL

Mr. APOLINSKY. Thank you.

I feel privileged to appear today on behalf of the Small Business Council of America. I am a tax lawyer, having practiced for over 25 years doing estate planning. For over 15 years, I have taught estate planning at both the Cumberland School of Law in Birmingham and the University of Alabama School of Law.

As I sit here and listen to this, the testimony offered, and I consider the many hours of effort put in by your staff and by others, I am reminded of a wonderful book by Professor James de Bono, entitled "Lateral Thinking." He cautions that before we begin to solve a problem, before we look at alternatives and complexity, we move laterally to be absolutely sure we indeed have a problem. Because if we do not have a real problem, the solution is apt to cause the problem.

My point is that I believe that we should have thought about de Bono's book in 1987. I do not think there was a real problem out there that needed to be addressed with 2036(c) and the type of effort that is being given to this.

I have done maybe 20 freezes in my practice. With every one, I have used a qualified appraiser. My valuation would stand up under an IRS microscope. It bothers me that the fees of the appraisers exceeded the fees for the legal work in many cases, but I felt that was necessary.

In teaching my classes, I have emphasized over and over again that tax lawyers doing estate freezes must engage quality appraisers. It is wrong to plan a client into a fight with the Internal Revenue Service. It is expensive and the client perceives that you failed and you will get fired.

It is as simple as that. I do not believe my standard of practice is much greater or better than the standard of practice of anyone else in this country. Estate planners know that their products will be looked at by the Service. Every will that we do for someone who has had a freeze, when that person dies, that will, that estate tax return will be read closely by the Internal Revenue Service. If there is a problem with the value at that time, it will be picked up.

That is why we are careful about doing it. I do not believe the level of abuses would rise to more than 1 or 2 percent. If there is need for more disclosure, the answer is to simply mandate disclosure of freezes on gift tax returns and require the furnishing of an appraisal with the return.

When there was a valuation question raised about charitable gifts in the middle eighties, that is what you did. The appraisal and the notification, and that seemed to me to cure the problem. When you started in February, Mr. Chairman, focusing on simplification, I was excited because I love to count the number of code subsections that have been changed in the last few years. The eight major tax laws in the last 9 years have changed over 8,200 code subsections.

My rabbi told me that tax law changes are intellectually stimulating and generate legal fees, and he is right. I asked him how he would like it if we changed the Torah every year. I think he understood my point of view.

The proposed 2701, 2702 and 2703 are 25 pages in length, to replace a four-page statute that did not work. The four-page statute produced a 77-page notice in August of 1989. I would really urge that the first example of simplification be the repeal of 2036(c), without substituting chapter 14.

Thanks very much for letting me share my thoughts with you. Chairman ROSTENKOWSKI. Thank you very much.

[The statement of Mr. Apolinsky follows:]

Statement of Harold I. Apolinsky
 For the Small Business Council of America
 Before the House Ways and Means Committee
 Concerning Proposed Chapter 14, Sections 2701, 2702 and 2703
 Repealing 2036(c)
 April 24, 1990

Mr. Chairman and Members of the Committee, my name is Harold Apolinsky. I am entering this statement into the record on behalf of the Small Business Council of America (SBCA), a nonprofit, nonpartisan national organization which represents the interests of small business organizations on Federal tax and employee benefit matters.

SBCA is an organization of approximately 1,000 small businesses, which provides a tax voice for the 17 million often overlooked small businesses in our country. With its leadership of tax experts, SBCA's primary goals are to prevent Federal tax laws from becoming more complex and burdensome for small businesses and their owners and to support legislation which creates needed economic incentives.

I am the managing member of Sirote & Permutt, P.C., an Alabama law firm, and have been practicing tax law for almost 30 years. Over 65 percent of my practice is estate planning. For over 15 years, I have taught estate planning at both the University of Alabama School of Law and the Cumberland School of Law. I presently also serve as President of the Estate Planning Council of Birmingham, and have held leadership positions in the American Bar Association Section of Taxation, the Alabama Bar Association Tax Section and the American College of Tax Counsel.

The subject of these hearings, Section 2036(c) and the proposed modifying legislation, is of major concern to small business and farm owners. The outcome of your findings and whatever corrective measures you undertake, be they outright repeal which we advocate or major simplification of this extremely complex, unwieldy and burdensome statute, will significantly impact many small business and farm owners who wish to pass ownership ultimately to their children.

The Small Business Council of America applauds the efforts of those members of Congress, most notably Congressman Archer and over 200 co-sponsors of H. R. 60, to repeal Section 2036(c). In the Senate, SBCA also applauds the bills to repeal Section 2036(c) introduced by Senators Boren, Daschle, Symms, Baucus and Heflin plus over 30 co-sponsors.

Section 2036(c) was adopted, without any hearings in the House of Representatives or the Senate, to stop family business owners from exchanging common stock which grows in value if the business becomes more valuable, for preferred stock which is frozen in value. This approach may have been first used by the DuPont family around 1935. It has been used by many family business owners for over 50 years.

Unfortunately, proposed Chapter 14, new Sections 2701, 2702 and 2703, effect the same result as 2036(c). Parents will not be able to transfer businesses and farms to children without significant and devastating estate and gift taxes, at a level of over 50%.

The vast majority of family businesses and farms will not be able to achieve a practical estate freeze if new Chapter 14 to the estate and gift tax laws is enacted. Owners will not be willing to commit to the cash flow mandated by the "qualified fixed payments". The alternatives provided will not help the owners. Thus, there will continue to be significant estate taxes levied on family businesses and farms preventing orderly transfers to family members.

It is wrong to force corporations to either declare preferred dividends or face gifts or inclusions for the holders of preferred stock under proposed Section 2701. The advisability of paying dividends is a business decision by boards of directors and depends upon profits, working capital needs, plans for expansion, etc. The holders of the preferred stock frequently will not have voting control and should not make or influence business decisions for their personal gain which might adversely affect other stockholders. They could be sued. The concept in 2701 of excusing dividends only in the event of bankruptcy or formal insolvency is thus flawed and should not be adopted.

Section 2702, as a practical matter, rules out all meaningful buy-sell agreements for family businesses. Buy-sell agreements containing formulas which may or may not equate fair market value at death are just as appropriate and necessary in family business situations as when the co-owners are not related. In fact, they may be more important in family situations. Such agreements are made when neither party is sure who will be the first to die, and thus contain safeguards from the marketplace, without the need for more statutory prohibition and rules.

For 25 years, the regulations under Section 2031 of the Estate Tax Law have set forth comprehensive rules governing buy-sell agreements. Regulations Section 20.2031-2(h) provides in part as follows (more complex rules are not needed):

"Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money and money's worth."

Section 2703 creates another set of family attribution rules. In fact, there are two new sets in this Chapter 14. Add this to the sets in Section 318 and 267, plus other provisions, and we may now be to an approximate total of ten different sets of family attribution rules.

Those of us working with the SBCA and other groups representing family businesses and farms were encouraged and excited when Chairman Rostenkowski, Congressman Archer and others a few weeks ago spoke of the need for simplification of the Tax Code. Individuals and especially owners of family businesses and farms can no longer cope with the complexity of the Code and the number of complex provisions and changes. Since 1981 the following changes have occurred:

<u>LAW</u>	<u>NO. OF CODE SUBSECTIONS CHANGED</u>
1981-Economic Recovery Tax Act (ERTA)	483
1982-Tax Equity and Fiscal Responsibility Act (TEFRA)	530
1984-Deficit Reduction Act (DEFRA)	-2,245
1984-Retirement Equity Act (REACT)	44
1986-Internal Revenue Code (EGSA)	2,704
1987-Omnibus Budget Reconciliation Act (OBRA)	231
1988-Technical and Miscellaneous Revenue Act (TAMRA)	1,588
1989-Omnibus Budget Reconciliation Act	462
<u>TOTAL CHANGES IN NINE YEARS</u>	<u>8,287</u>

Proposed Chapter 14 with new code Sections 2701, 2702 and 2703 is not a good start toward simplification. What is being suggested is 25 pages of new, complex statutory provisions to replace the four burdensome pages of 2036(c).

We urge that family businesses and farms be totally excluded from a person's gross and taxable estate. Families should be encouraged to keep and expand their businesses and farms.

Sections 2701, 2702 and 2703 must have been drafted by the same team that did 2032(A) in 1976. You may recall that Congress had a wonderful idea to let family farms be taxed as farms. This simple concept was unfortunately converted to 11 pages of statutory complexity. Many pages of regulations have only explained some of the questions. By latest count, there have been 80 court decisions deciding 2032(a) issues.⁴ Sections 2701, 2702 and 2703 will provide a wonderful bonanza for tax lawyers to litigate.

The number of abusive situations in the estate-freeze area were quite small, probably no more than two percent. Instead of 2036(c) or new Chapter 14, the IRS should be left to correct any abusive situations through audit. Virtually every estate-freeze transaction can be identified from either the review of gift tax or estate tax returns. Every estate tax return filed is currently reviewed.

If the IRS needed better reporting, it would be simple to substitute for 2036(c) and proposed Chapter 14 the filing of a gift tax return together with a qualified appraisal of any interest transferred in an estate freeze. This simple approach was used to reduce valuation concerns regarding gifts to charities.

Is it not more consistent with our system of free enterprise and entrepreneurial spirit to encourage family owned business and farms to grow, be productive and stay within the family? The goal of 2036(C) and Sections 2701, 2702 and 2703 is to force the most successful family businesses and farms to be sold or liquidated to pay the very burdensome 55 percent gift and estate taxes.

Following are a few examples of the adverse effect Section 2036(c) and proposed Sections 2701, 2702 and 2703 have and will have on family businesses and farms.

Example 1Facts:

In 1950 Husband formed a successful partnership with Wife. Through the years they made gifts of their general partnership interest having a value equal to the gift tax annual exclusion to their Son. In 1988 when Husband retired, he still retained a majority interest in the partnership. However, upon Husband's retirement Husband and Wife exchanged for full value all of their general partnership interest for a limited partnership interest. They maintained certain preferred rights including a right to the profits of the partnership interest but only until Husband and Wife had received an amount equal to 10% of the beginning capital account of their preferred limited partnership interest. This preferred income right was cumulative and gave Husband and Wife the right to call upon future profits to compensate in the event of underpayment. Upon liquidation Husband and Wife were entitled to receive an amount equal to their beginning capital account. Other than the income and liquidation rights of Husband and Wife, Son's general partnership interest is entitled to all profits and any assets from liquidation. By its terms, the partnership will terminate in 1995.

Results under Section 2036(c):

Upon termination of the partnership, a gift tax will be triggered under Section 2036(c). The full value of the enterprise will be considered a gift by Husband and Wife at that time. Husband and Wife will receive consideration offsets for portions of the enterprise owned by Son before the gift or still owned by Husband and Wife on the valuation date. Section 2036(c) will force a gift tax to be paid even though the original exchange was for full value and even though the return paid to the Husband and Wife by means of the preferred limited partnership interest exceeds the growth of the enterprise. In this situation Section 2036(c) may put unexpected burdens on the partnership exchange leaving Husband and Wife without liquid funds with which to pay the gift tax.

..4..

Results under Sections 2701-2703:

Without some additional guidelines it is difficult to answer exactly how the retained interest would be valued in this example. The result would depend on whether the Husband and Wife's limited partnership interest could be defined as a Qualified Fixed Payment (QFP). The income interest would only be qualified if fixed as to amount and time for payment. Under 2701(b)(1)(A)(i), the interest could not be tied to a percentage of corporation profits. Under 2701(b)(1)(A)(ii), the payment rate could be variable but only if tied to a fixed market interest rate. The liquidation rights would probably not meet the requirements of a QFP therefore, this value would be zero.

In addition to the importance of a fixed amount, the income interest needs to have a set termination date or a provision to pay in perpetuity. The existence of a life contingency disqualifies the payment as a QFP under Section 2701(b)(1)(c). In Example One the agreement provided for payment until the Husband and Wife received 10% of their beginning capital account. Arguably, this is a fixed termination provided for in the agreement. Regulations will probably be needed to more clearly define these termination requirements.

Example 2Facts:

Father owned a majority of the voting common stock of a closely held business which he and his family had owned and operated for a number of years. Father's business was successful and he found himself needing more employees. Father hired twenty new employees and as an incentive program offered each new employee an equity ownership in the enterprise through a stock option program. None of the employees were family members except Father's daughter. Through the stock option plan, Daughter acquired a 10% ownership interest in the corporation at the time of Father's later retirement. Under Father's retirement plan his stock was redeemed for a note that matures in 2004. In addition, he is entitled to receive benefits under a salary continuation plan even though he is no longer performing services for the corporation. The debt is never reduced and Father dies in 1990.

Results under Section 2036(c):

Section 2036(c) will cause part of the enterprise to be included in Father's gross estate. Father indirectly conveyed part of his interest in the enterprise to Daughter when the corporation redeemed his stock under his retirement plan. Daughter had a greater interest in the potential appreciation after the redemption of the stock and Father retained an interest in the corporation through his note and salary continuation plan. The amount includable in Father's gross estate will be the full value of the enterprise, adjusted for the value of the non-family member ownership, the value of Daughter's interest in the enterprise in 1988 compared to Father and Daughter's interest in the enterprise in 1988, the value of the interest and Father's note and salary continuation. In addition to these offsets, the 10% share of consideration that Daughter received on Father's retirement divided by the value of Daughter's interest in the enterprise on Father's retirement can be taken as a family member consideration offset.

Section 2036(c) will force the closely held business to avoid hiring family members and providing any equity ownership incentives to these members. The traditional goal of many closely held corporations before Section 2036(c) was to maintain family characteristics. That goal has been made much more difficult in view of estate taxes after the passage of Section 2036(c).

Results under Sections 2701-2703:

The result would remain the same under the new sections. The Summary of the Discussion Draft states that the treatment of a QFP valuation is designed to "ensure that discretionary rights which are likely not to be exercised in an arms length manner cannot be used to understate the value of the property transferred." The above statement gives the approach of Sections 2701, 2702 and 2703. The retained rights would probably not meet the requirements of a QFP. The debt although fixed in time remains unpaid in the example. This debt would not be defined as true debt under Section 2701(c)(2)(B) because the debt instrument provides for no mechanism for payment of accrued interest or unpaid principal in future years. The value of the debt for gift tax purposes would be zero.

The Discussion Draft states that employment agreements will not be affected by these new rules. They are not specifically addressed by the new proposed sections. We may have to depend on regulations to more clearly outline how to determine the valuation of such contracts. Under this example, whether the agreement can truly be classified as an employment agreement is also left open to doubt. Whether one could assign some value outside the proposed rules to reduce the transferred interest for gift tax purposes is uncertain.

Example 3

Facts:

Father and two Sons form a limited partnership that is not subject to taxation under Section 2036(c) but for an unqualified buy-sell agreement. At the formation of the partnership, the partners had entered into a buy-sell agreement providing for the right of first refusal if any partner attempted to sell his limited partnership interest.

Results under Section 2036(c):

Section 2036(c) provides safe harbors for buy-sell agreements which utilize formulas that approximate fair market value of the interest in the enterprise. The effect of a right of first refusal on the value of a partnership interest may decrease that value by as much as 30% according to the Estate of Hall v. Commissioner, 92 T.C. 318 (1989). Therefore, Section 2036(c) will bring into the Father's estate part of the enterprise because the buy-sell agreement did not approximate fair market value of the enterprise at Father's death. Because the Father's life expectancy was considerably shorter than that of the other partners, his partnership interest had a low potential of appreciation, thus entering into the partnership he made a deemed conveyance to his Sons of a disproportionately larger share of potential appreciation while retaining an interest in the enterprise. His estate would have to pay estate tax on the value of the partnership minus the value of his ownership interest in the enterprise at the time of his death. In addition, his estate would get an adjustment for that portion of the enterprise owned by Father's family prior to that partnership agreement.

The effect of Section 2036(c) language has basically caused simple right of first refusal buy-sell agreements which have been a practical part of any business planning to be costly and unusable in the family situation.

Results under Sections 2701-2703:

Proposed Section 2702 addresses various contract options and their valuations. The option will be valued under Section 2702 without considering rights such as first refusal, price options which value property at less than fair market value, or leasing rights. It appears that proposed Section 2702 and Section 2036(c) both have a similar purpose designed to force buy-sell agreements among family members to reflect fair market value more accurately. The exemptions provided for under Section 2702 reflect in substance the safe harbor for buy-sell agreements under Section 2036(c). For purposes of this section "family" is defined as in Section 2036(c).

Example 4Facts:

Husband and Wife have assets which consist of 3 million dollars basically composed of a house and personal items totaling 1 million, and the family farm operated by a corporation and worth 2 million. A trust owns a second-to-die insurance policy that is designed to provide liquid funds for the payment of estate taxes. Anticipating growth and desiring to keep the farm within the family, Husband and Wife decide to recapitalize the farm stock and freeze the value of the farm at 2 million dollars for estate tax purposes. Husband and Wife retain preferred stock with preferred dividends and liquidation rights. Ten years later the farm has appreciated to 4 million dollars.

Results under Section 2036(c):

Before the passage of 2036(c) at the death of the second to die of Husband and Wife, the use of their unified credits and life insurance policy proceeds would have enabled their estate to pay the approximately 1.3 million dollars owed in estate tax, leaving their family assets intact. However, since the passage of Section 2036(c), Husband and Wife will not be able to maintain this estate plan without incurring additional tax. The prohibited Section 2036(c) exchange will cause the value of the enterprise (farm) at death (4 million) to be brought back into the estate leaving an estate tax liability of approximately 3.3 million. Insurance proceeds will not be sufficient to cover the additional 2 million dollars in tax captured by Section 2036(c). Their options are limited because their children have always worked on the farm and earned wages from the enterprise; therefore, no money that had been obtained outside the enterprise (clean money) would exist within the family to purchase the farm out of the Husband and Wife's estate avoiding Section 2036(c) problems. The result for the family will probably be that the family farm will have to be sold to pay the estate taxes.

Results under Sections 2701-2703:

The transfer would be immediately valued as a \$2 million gift for gift tax purposes. The value of the gift would be reduced by the market value of the preferred dividends if those dividends meet the definition of a QFP. The dividends would have to be cumulative, payable on a periodic basis, and determined at a fixed rate. In addition, the dividends could not be tied to any life contingency. Assuming that the dividends in this example meet the definition of a QFP, the value of the gift is reduced by the value of these dividends. However, it must be noted that part of this reduction will be later recovered in the husband's or wife's estate should they die owning stock (2071(d)(2)) or in the form of additional gift tax should the stock be subsequently transferred (2071(d)(1)). The amount of the gift or the amount included in the gross estate will be increased by the amount that the dividends decreased the value of the initial transfer. Therefore, the proposed sections under this section will cause initial gift liability and, in addition, may cause future estate tax liability. Whether the overall tax burden under the new sections would be greater than under 2036(c) would depend in large part to the amount of appreciation attributable to the property transferred. In addition to these problems, the new proposed sections may cause the family financial problems upon the initial transfer due to the gift tax. In this example, no funds are available for taxes before second to die of the Husband and Wife.

Example 5Facts:

Son owns a company which he has built and established with money not received from his family. The corporation has 50 shares of single class common stock outstanding, all of which are owned by Son. The stock has a value of \$100,000. Son's company is having some financial difficulties, and Son's Father agrees to contribute to the company's capital \$50,000 in exchange for 25 shares of par value preferred stock redeemable at par value. The capital contribution allows Son's company to expand and enhance productivity.

Results under Section 2036(c):

Before Section 2036(c) this contribution would have been an acceptable way to assist family members without increasing estate tax liability. However, since Section 2036(c) the result of the above exchange would be to include the value of the enterprise in Father's estate because he has made a deemed disproportionate transfer. Father's actual share of appreciation is zero; therefore, he is deemed to have conveyed one third of the appreciation to Son in exchange for a preferred income stream and depreciation protection. Section 2036(c) makes it difficult for family members to assist or contribute to family business without risking inclusion of portions of the enterprise in one's estate.

Results under Sections 2701-2703:

Under Section 2703(c), contributions to capital that have "substantially the same effect" as transfers of interest by a member of the family are treated as transfers under this section. It is unclear how this section will affect examples like this one. The terms are undefined and leave much room for interpretation. The section also provides for exemptions as provided in later regulations. How these future regulations will interpret Section 2703(c) with relationship to changes in capital structure is yet unknown.

Assuming that the example would be treated as a transfer under these sections, the dividend right may be a QFP that will lower the value of the initial gift. Section 2701(a)(2)(B)(ii) offers a favorable assumption that if no fixed termination date exists the payment will be assumed to be made in perpetuity. Therefore, the only questions which remain are whether the payment is fixed as to amount and whether it is cumulative as required by Section 2701(b)(1)(A)(ii). If the payments are both fixed and cumulative, the value of the \$50,000 gift will be decreased by the value of the dividend right. If they are not, the value of such rights will be zero, leaving the value of the gift at \$50,000. However, as in Example Four, it must be noted that part of any reduction will be recovered in either the Father's estate should he die owning the stock or in gift tax should he later transfer the stock.

Example 6Facts:

Father and Son wish to jointly purchase real estate for investment purposes. They jointly purchase a piece of property for \$200,000. The Father purchases a life estate and Son purchases the remainder in the property. Father pays \$150,000 which has been determined to be fair market value of a life estate using current valuation tables. Son furnishes \$50,000 which has been determined to be the fair market value of the remainder interest.

Results under Section 2036(c):

Because of the nature of their purchase, it is deemed an enterprise and Father is deemed to have transferred 75% of the potential appreciation in the value of the land to the Son in exchange for the Son's 25% interest in the income or rental value of the land. Thus, Father has made a disproportionate transfer and the value of the enterprise would be brought back into his estate upon his death.

Results under Sections 2701-2703:

The new proposed section deals with joint purchases in 2703(d). This section states that when two or more members of a family jointly acquire interest in property the individual which receives the term interest is treated as having acquired the entire property and subsequently transferring to the other persons their respective interests in such property. A term interest can be defined as either a term of years or lifetime. The Father will be treated as having made a gift of \$50,000 to the Son.

As was the case under 2036(c), it is very difficult to analyze specific examples without the benefit of any explanation or definition of the terms within these proposed sections. As with Section 2036(c), we will probably have to wait for an explanation from the Service before all of the questions can be answered.

Example 7

Wallace v. U.S., 566 F. Supp. 904, 49 AFTR 2d 82-1482, is an excellent example of the real risk parents take in making gifts as part of an estate-freeze. It also shows that an appraisal can be quite accurate.

The Wallace brothers made gifts in 1972 of common stock to trusts immediately after recapitalization of their corporations (classic freeze) as part of an estate plan. The value of the gifts was determined by an independent appraisal firm.

In 1973, the brothers paid over \$440,000 of gift taxes with timely filed gift tax returns. Unfortunately, the value of the corporations dropped.

In 1976, the brothers sought a refund of the gift taxes paid claiming the appraisals on which they relied in reporting the gifts excessively valued the donated shares. The brothers lost.

Chairman ROSTENKOWSKI. Thank you very much, ladies and gentlemen, for joining us here this morning.

Our next witness is Don Lubick.

STATEMENT OF DONALD C. LUBICK, ESQ., CHAIR, TAX POLICY COMMITTEE, SECTION OF TAXATION, DISTRICT OF COLUMBIA BAR, AND PARTNER, HODGSON, RUSS, ANDREWS, WOODS & GOODYEAR, WASHINGTON, DC, ACCOMPANIED BY JANE C. BERGNER, CHAIRMAN, SECTION OF TAXATION, AND GEORGE LEVENDIS, CHAIRMAN, SECTION 2036(c) TASK FORCE

Mr. LUBICK. My name is Don Lubick, chairman of the tax policy committee of the District of Columbia Bar, and with me is Jane Bergner, who is the chairman of our tax section; and George Levendis, who is chairman of the ad hoc committee that dealt with this particular problem. Also on the panel as an invited witness is Mr. Aucutt, who participated in our work.

I would like to simply point out that everybody seems to agree that the problem that requires legislative solution in the estate freeze situation is the problem of valuation. We seem to have unanimity on that, and the 2036(c) approach is not a workable approach.

The discussion draft attacked the problem, in our judgment, in a needlessly complex way. It has been pointed out by earlier testimony that this is to be the year of simplification, yet the discussion draft would value any business arrangement that doesn't meet its standard at zero, something that is contrary to fact.

It would then require a revaluation subsequently at death to compensate for the misvaluation earlier. It requires a minimum valuation of 20 percent for junior equity, again, something which in very many cases would be contrary to fact.

And it requires all kinds of special rules, elections and adjustments. We have learned already there will have to be a number of technical amendments. I suggest that we are going to have another statutory monster.

Now, we believe that if the problem is valuation, let's attack that problem head on. We asked why has valuation been so difficult for the Internal Revenue Service in those cases where there are abuses? We believe there are two reasons for this.

One, there have been some ill-advised substantive rules of valuation developed by the courts, and second and most often IRS has been operating under a procedural handicap of not learning about these estate freeze valuation problems in a timely fashion.

Therefore, one can go at this problem simply directly and in a straightforward way without the need for all of the complications.

First of all, let's eliminate the bad decisions in calculating value. We have suggested two particular specific areas where there can be change. One is the elimination of an unrealistic minority discount in a transfer, in a 2036(c) situation among family members. It is not really right to simply base your valuation on what is transferred without reference to the fact that the transferor and the transferee are operating together to control the particular corporation.

Second, in a number of situations, there has been a mandated use of table valuations, which are based upon interest assumptions that are totally unrealistic, or on mortality assumptions that are also unrealistic.

We suggest that in appropriate cases, both the IRS and the taxpayer ought to be able to deviate from these rigid assumptions which produce inappropriate results.

If there are other valuation abuses, let the case be made, and they can be dealt with specifically, but I believe we have dealt with the major ones.

Next, we should put sunshine on these transactions in order to give the IRS the chance to scrutinize them. We have suggested that we have an increased reporting procedure, and an extension of the statute of limitations. Even in cases of sales, and in cases where the value of the transferred interest is reported at zero and, hence, under the exclusion, there ought to be a report.

We would allow looking at post-transfer facts as evidence of value. We would limit the credit at death to the tax on the valuation reported. We believe that we have responded to those concerns that Mr. Gideon expressed this morning about soak-up rights.

We do not believe new major principles of law are required. If these matters can be brought to the attention of the IRS and dealt with directly, the abuses can be eliminated.

Mr. LEVIN [presiding]. Thank you.

[The statement of Mr. Lubick follows:]

TAXATION SECTION



The District of Columbia Bar

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**STATEMENT OF DONALD C. LUBICK
CHAIR, TAX POLICY COMMITTEE**

**ON BEHALF OF SECTION OF TAXATION OF THE DISTRICT OF COLUMBIA BAR
BEFORE THE COMMITTEE ON WAYS AND MEANS, APRIL 24, 1990**

I. Introduction

The Section of Taxation of the District of Columbia Bar¹ appreciates the opportunity to comment on both the modification of Section 2036(c)² and the Discussion Draft (the "Discussion Draft") released on March 22, 1990. We also offer a proposal (the "Proposal") that incorporates many of the principles of the Discussion Draft but that, in a number of areas, achieves the objectives of the Discussion Draft more simply and consistent with familiar and established legal concepts.

Section 2036(c) was enacted as a part of the Omnibus Budget Reconciliation Act of 1987 ("OBRA 87") to enable the Internal Revenue Service to deal with avoidance of transfer taxes through various devices generically referred to as "estate tax freezes." By using one of these devices a transferor could retain, substantially intact, his interest in the current benefits of ownership of a business, such as management and control and its current income stream, yet still be able to pass increases in its underlying value to his beneficiaries without transfer tax. In the abusive cases, the transferor overvalued the retained interest and valued the donated interest at zero or at a grossly inadequate value.³ The classic preferred stock recapitalization and many complex variations on that theme have caused avoidance of transfer taxes, either because the valuation rules before enactment of Section 2036(c) were inadequate to deal with them or because the Service has had inadequate means to detect undervaluations of transferred interests.

Instead of dealing with valuation abuse, Section 2036(c) changed the substantive rules of transfer taxation by a sweeping inclusion, generally at death, of interests transferred during lifetime by an individual who retains an interest in an underlying "enterprise" apart from property that has been unconditionally and irrevocably transferred. The new law extends well beyond the principal abuse that prompted its enactment, namely undervaluation of the transferred interest in future growth. The statute attempts to cover all intrafamily transfers within the statute's parameters regardless of the correctness of any reported values.

Section 2036(c) has been criticized on all sides, both for introducing expanded new concepts of taxation of property in cases where the transferor has retained no traditional "string" over the transferred property and for its unworkability because of ambiguous and difficult-to-define terms that trigger its application. Such criticism

¹ The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,400 members.

² "Section" references are to the Internal Revenue Code of 1986.

³ Even if the property were properly valued at the time of transfer, the Service found it difficult to discover the subsequent transfers when rights incident to property retained by the transferor were allowed to lapse or were not exercised in an arm's-length manner.

continues notwithstanding good-faith efforts of both the Congress and the Internal Revenue Service at refining and clarifying the statute, by amendment of the statute in the Technical and Miscellaneous Revenue Act of 1988 and administratively in IRS Notice 89-99.

Section 2036(c) differs in its approach from the accepted reach of Section 2036(a) in the "reserved life estate" situation. Section 2036(a) taxes property passing to a remainderman on the death of a transferor life tenant because the transferor has retained a continuing interest in the same physical property that was transferred. In contrast, Section 2036(c) taxes an individual on the future value of property previously transferred by such individual solely on the ground that the transferor holds a separate interest in the underlying entity in which the transferred property also is an interest. Retention of control of the common enterprise by virtue of a different and separate interest in the entity is in itself an insufficient basis for taxation, as has been recognized, since neither Section 2036(c) nor the Discussion Draft would impose a tax on transferred property solely by virtue of retention by the transferor of voting rights. For example, neither the transfer of nonvoting stock while retaining all voting power nor the transfer of minority stock while retaining majority control is sufficient under either Section 2036(c) or the Discussion Draft to include the transferred property in the transferor's taxable estate. Our estate tax law, even under Section 2036(c) and clearly under the Discussion Draft, recognizes that parallel interests in business entities can exist side by side and be recognized as discrete interests in different property. Hence, the rationale for determining abuse can only be that the retained property has been overvalued, and, conversely, that the transferred property undervalued.

In point of fact, Section 2036(c) discourages proper and desirable intrafamily planning. It is entirely appropriate for an older-generation individual to pass an interest in the family business to descendants, with payment at the time of appropriate transfer tax, even though retaining control until it is clear that the transferees are adequate to assume the mantle of management. The post-transfer value, perhaps created by the transferees' efforts, should not be brought back into the parent's estate solely because the parent retains a preferred interest in the business to provide, for example, income for old age.

We recognize that Section 2036(c) properly addresses an area of tax avoidance. Accordingly, our Proposal in replacement of Section 2036(c) offers a solution that makes no change to substantive concepts of estate and gift transfer taxation under pre-OBRA 87 law but that, nevertheless, gives the Service the tools it needs to address substantially all the perceived pre-OBRA 87 abuses. Limiting the remedy to proper valuation avoids the needless complexity inherent in tampering with established property-law concepts. The Discussion Draft is a welcome step in the proper direction. However, it too adopts complex new property concepts and expands transfer-tax law beyond abuse cases. Even though the statutory scheme of the Discussion Draft is valuation based, by treating nonconforming retentions as having zero value, it, in effect, changes substantive property law and results in transfer taxation of future appreciation, in an intrafamily context, arising after completed transfers and fair market value sales.⁴ *In a system that depends in large measure on self-assessment, the rules must be both reasonable and intelligible.*

II. Summary of the Proposal

Our Proposal reflects our experience that underlying practically all the pre-OBRA 87 estate tax freeze devices that can fairly be characterized as abuses are one or both of two handicaps of the Service. The first is the inadequacy of rules for determining valuation of *inter-vivos* transfers. The second is the inadequacy for the Service of reporting and auditing tools. We propose changes in the rules respecting

⁴ See §2701(a) of the Discussion Draft in which a so-called "qualified fixed payment," with limited exceptions, would be the only kind of retained interest a transferor could safely hold.

(i) valuation for transfer tax purposes, (ii) the reporting of transfers and (iii) the pertinent statutes of limitation, to place the Internal Revenue Service on an equal footing with the planners of sophisticated estate tax freeze devices. At the same time, in contrast to the "look back" approach of both current Section 2036(c) and the Discussion Draft, our Proposal will not extend the reach of transfer taxes to apply to changes in value of an asset in the hands of an irrevocable and unconditional transferee who is fully at risk as to the value of the transferred asset.

- The Proposal would apply to Section 2036(c) situations where (i) the transfer involves an "enterprise," as currently defined under section 2036(c); (ii) the transferor retains an interest in the enterprise post completion of the transfer; and (iii) the transferor and the transferor's family own before completion of the transfer more than 10 percent of the enterprise.

- In a Section 2036(c) situation, all transfers must be reported by the transferor on a gift tax return⁵ for the year of transfer, even if the transfer (i) is within the annual exclusion amount or (ii) is a *bona-fide* transfer for value. The reporting rules would include specific disclosure requirements to be prescribed by Treasury Regulations.

- All prior transfers in Section 2036(c) situations must again be reported on an estate tax return of a transferor.

- For transfers in Section 2036(c) situations, (1) generally, a minority interest discount will be unavailable; and (2) either the Service or the taxpayer may value transferred property without regard to the Treasury's actuarial tables in cases where it can be established that the nontabular valuation more closely reflects the actual income produced by the enterprise and mortality factors.

- In a Section 2036(c) situation, if a transfer is reported on a gift tax return and is audited by the Service within the applicable statute-of-limitations period, the Service is permanently foreclosed from revaluing the property transferred either for gift-tax purposes or for subsequent estate-tax computation purposes upon the death of the transferor.

- In a Section 2036(c) situation, if a transfer is properly reported on a gift tax return, but if such return is not audited, then the Service is foreclosed after expiration of the statute of limitations from revaluing the property transferred for the purpose of redetermining gift tax, *but* the Service may revalue (with the burden of proof) the property for estate tax purposes in connection with the tentative tax computation under Section 2001(b)(1) and limit the Section 2001(b)(2) offset to the actual gift tax paid with respect to the transfer.⁶

- If, in a 2036(c) situation, a transfer is not properly reported on a gift tax return, then the statute of limitations will continue to remain open with respect to the transfer, and the Service may subsequently revalue the transferred property *both* for gift tax purposes *and* for the purpose of making the tentative estate tax computation at death under Section 2001(b)(1).

- With respect to a transfer in a Section 2036(c) situation, the Service may assess, within the statute of limitations, a substantial undervaluation penalty in either a gift tax proceeding or an estate tax proceeding, but *not* in both. If there has been full return disclosure of a transfer, however, the Service will have the burden of

⁵The form required by the Service may be an informational return, other than a Form 709, in cases such as a claimed annual-exclusion gift or a *bona-fide* transfer for value.

⁶This is in contrast with current Section 2001(b)(2) which apparently permits an offset of the aggregate amount of tax which would have been payable if the provisions of Section 2036(c) in effect at the decedent's death had been applicable at the time of the gift.

proof with respect to assertion of the penalty in the estate tax proceeding, assuming no gift tax audit was conducted. If, on the other hand, a timely gift tax audit is conducted by the Service and the Service does not assert a penalty, it is foreclosed from asserting the penalty in the subsequent estate tax proceeding.

- An expanded six-year gift tax statute of limitations will apply to transfers in Section 2036(c) situations, thereby providing the Service with sufficient time to marshal its facts on a retrospective basis and conduct an adequate review of the valuation placed on the property transferred.

- At any time after a disclosure of Section 2036(c) type transfer, whether or not within the six-year statutory period, a taxpayer may file with the Service a request to review the transfer. The Service then will have until the later of either (i) the expiration of the six-year limitations period or (ii) the period ending two years after the request to audit the taxpayer's gift tax return with respect to the transfer. If it fails to conduct an audit within the statutory period, the Service will be foreclosed from revaluing the property transferred either for gift tax purposes or for the purpose of the tentative estate tax computation under Section 2001(b)(1).

- The Proposal explicitly recognizes that periodic gift taxation may result where certain post-transfer discretionary action or inaction by the taxpayer inures to the benefit of the transferee.

III. Discussion of Proposal in Substitution for Section 2036(c)

A. Limitation of Changes to "Section 2036(c) Situations." Our Proposal would only apply to transactions currently within the scope of Section 2036(c). Thus, as under current Section 2036(c), we would apply the new rules where (a) the transfer involves an enterprise, (b) the transferor retains an interest in the enterprise post completion of the transfer and (c) the transferor and the transferor's family own before completion of the transfer more than 10 percent of the enterprise.

We recognize that, thereby, we have retained some of the imprecision that justifiably subjected Section 2036(c) to criticism as causing hardship for taxpayers engaged in legitimate planning. The critical difference is that we are retaining in our Proposal the scope of Section 2036(c) and its definitional terms as a procedural matter only. No taxpayer's substantive liability is changed. Our tolerance for giving the Service latitude in definition is, therefore, significantly greater than is the case under either current Section 2036(c) or the scheme of the Discussion Draft.

Further, we suggest new review and disclosure procedures that will enable taxpayers to determine with certainty the effects of their transactions and will give the Service adequate tools and time to effectively evaluate the transactions, thereby forcing both taxpayers and the Service to place their cards on the table.

The situations to which our Proposal applies are called "Section 2036(c) situations."⁷

B. Valuation Procedure

1. Minority Interest Discount. In a Section 2036(c) situation, valuation of property transferred to a family member (as is currently defined in Section 2036(c)(3)(B))⁸ will be made without any reference to a discount for lack of control inherent in the transferred property. Taxpayers have frequently avoided taxation of a transfer, in substantial part, by looking only at the property transferred and claiming a discount for its status as a subordinate minority interest. Since the

⁷ Examples of such situations include, but are not limited to, preferred-stock recapitalizations.

⁸ An individual's spouse, lineal descendant or lineal descendant of such spouse, an individual's parent or grandparent, or the spouse of any of the foregoing.

transferor in a Section 2036(c) situation has retained an interest in the enterprise associated with the transferred property, it is logical to value the transferred property as if it were associated with the retained property, instead of as a minority interest. Of course, if the retained and associated property *combined* would have been valued under pre-OBRA 87 law as subject to a legitimate minority-interest discount, the value of the transferred property in a Section 2036(c) situation would be determined with appropriate allowance for its share of the minority-interest discount applying to the combined property.⁹

2. Artificial Valuations by Application of Treasury Actuarial Tables.

Taxpayers have frequently taken advantage of actuarial tables, set out in the Treasury Regulations and Notice 89-60, to justify artificially low valuations of property transfers involving split interests such as life estates and remainders. The actuarial tables assume both a standard interest rate and consistent mortality experience. If, for example, a transfer of a remainder in appreciating, nonincome-producing property is valued from the tables, there will be a serious undervaluation of the remainder.

a. **Right to Ignore Tables.** Either the Service or a taxpayer may value a transfer without regard to actuarial tables if the proponent of the nontabular valuation establishes that the income or mortality assumption of the tables is likely to be, or, in certain cases, was in fact, substantially different from the actual income produced or mortality factor experienced in connection with such transfer. Thus, *solely* on the question of use or deviation from the actuarial tables, the retrospective use of the pertinent actual facts may be applied in a Section 2036(c) situation as evidence of the reality of the original assumptions at the time of the transfer, unless the factual deviation from the tabular actuarial assumption is due to circumstances not foreseeable at the time of the transfer and is attributable to factors beyond the reasonable control of the transferor or transferee.¹⁰

The following examples are illustrative. One: A taxpayer transfers common stock in a corporation to a family member and retains all of the preferred stock and one share of the common. The preferred stock carries a dividend based on earnings. The taxpayer uses an eleven-percent interest-rate assumption in valuing the preferred stock, even though the applicable tables use a nine-percent rate. The taxpayer is permitted to depart from the tables because he or she is able to show that eleven percent was a reasonably anticipated dividend rate for the corporation. On audit, the Service will use actual experience as evidence of the realism of the assumption. Two: A taxpayer transfers a remainder interest in stock using a valuation table that assumes a nine-percent interest rate. No dividends are paid for three years after the transfer. The Service may use the fact that no dividends were actually paid to show undervaluation, three years earlier, of the remainder interest. If, however, the taxpayer shows that dividends of approximately the assumed income rate historically had been paid and that the cessation of dividends was due to extrinsic and unforeseen post-transfer circumstances, outside of the transferor's control, the taxpayer's valuation may be accepted as realistic.

⁹ While we address only the Section 2036(c) situation, in theory, the reasoning might apply as well to disallow a minority-interest discount in a situation where the transferor and transferee have a similar relationship.

¹⁰ The Proposal confirms that, under existing law, if the transfer of common stock is reported, dividends are paid during the applicable statute of limitations period, the transfer is audited by the Service and the taxpayer's valuation is sustained, then, any failure to pay dividends to the holder of the retained interest in a year subsequent to the expiration of the statute of limitations — because of factors within the reasonable control of the transferor — may be a gift to the holder of the transferred interest in the year of such failure and may be included in the transferor's estate for the purpose of determining the estate tax at the transferor's death based on the value of all lifetime and testamentary transfers. Of course, if the statute of limitations has not run, the Service can use the fact that no dividends were paid during the statutory period as evidence of undervaluation of the originally transferred interest on the gift tax return.

b. **Procedural Rules in Cases of Disregard of Tables.** The actuarial tables will continue to carry the presumption of correctness in a Section 2036(c) situation, and the party valuing a transfer on the basis of a different assumption will carry the burden of proof on that issue. Furthermore, a taxpayer who values a transfer of a split interest in property without regard to the actuarial tables will be required to disclose such disregard of the tables in order for the statute of limitations to run with respect to such transfer.

c. **Disclosure, Reporting and Statutes of Limitation.** The general principle supporting the aspects of our Proposal in respect of disclosure and extended statutes of limitation is that the Service must be given notice and opportunity to audit a transfer in a Section 2036(c) situation. Too many taxpayers have relied upon their own valuation, without the Service having a reasonable chance of review, to take a position that a transfer is either within the federal gift tax annual-exclusion amount (i.e., under \$10,000 per donee) or supported by an adequate, yet nominal, consideration. Statute-of-limitations questions arise with respect to each *inter-vivos* transfer, as well as with respect to inclusion of lifetime gifts, to ascertain the decedent's transfers (during lifetime and at death) reportable on the estate tax return of a deceased taxpayer as the basis for determining the estate tax.

1. **Disclosure Requirements.** In a Section 2036(c) situation, a transfer must be reported contemporaneously by the transferor, regardless of whether the taxpayer claims the transfer to be either within the annual gift-tax exclusion amount or a sale supported by adequate consideration. The Proposal contemplates that Treasury may prescribe by Regulations the information required to be reported in any such situation. In addition to such annual reporting, all Section 2036(c) situation transfers made by a decedent during his or her lifetime must be reported on the transferor's estate tax return after death.

2. **Statute of Limitations - Gift Tax.** A critical facet of our proposal is a new statute of limitations with respect to gift tax in Section 2036(c) situations. In such situations, the Service will have until the later of either (i) six (6) years after the date the gift tax return for the year of the transfer is filed (treating a return filed before its due date as if filed on such due date) or (ii) two (2) years after the date of a taxpayer request for review of a gift tax return, a proposed new procedure described in III.D., below. A gift tax statute of limitations longer than the historic three years is necessary because the Service currently does not have adequate time to properly evaluate gift transfers in Section 2036(c) situations.

The gift tax statute of limitations will not run and, therefore, will not preclude the Service from revaluing a Section 2036(c) situation transfer (i.e., determining its fair market value at the date of transfer), for gift-tax purposes, unless:

a. There has been adequate disclosure of the transfer in accordance with Regulations;¹¹ or

b. There has been a determination of value after an audit by the Service, including an audit under the new review procedure described in III.D., below.

Thus, the Service will not be precluded from asserting liability by a taxpayer's failure to inform it of an audit opportunity. On the other hand, if there has been adequate reporting of a Section 2036(c) transfer by a taxpayer within the statutory period, once the statute of limitations has run, the Service will be precluded

¹¹ As indicated earlier, such disclosure might be on a Form 709 filed with respect to the transfer or, in the case of gifts that come within the annual-exclusion amount or transfers not characterized as gifts (e.g., transfers for consideration), on another form prescribed by the Service.

from adjusting, for gift tax purposes, the value of a gift in a Section 2036(c) situation, and it will have the burden of proof with respect to an estate tax adjustment.

In addition, if there has been an actual gift-tax audit of the value of the transferred property, the Service will be precluded from adjusting, for estate tax purposes, the value of such a gift in connection with the estate tax return filed at the transferor's death. The termination date with respect to the gift-tax valuation of Section 2036(c) transfers will provide taxpayers with a degree of certainty, thereby promoting compliance. By the same token, the longer, six-year statute of limitations assures the Service that the comfort given taxpayers by such possibility will not be granted at the expense of its adequate audit opportunity.

Both Section 2036(c) and the Discussion Draft are considerably more complicated than our Proposal because of their respective "look-back" requirements. In particular, we note that the Discussion Draft would require such a "look back" on the first to occur of (i) a subsequent transfer of the transferor's retained rights in circumstances where such rights originally were valued, under the Discussion Draft, at zero, and (ii) the death of the transferor.

3. Statute of Limitations - Estate Tax Return. The statute of limitations will not preclude the Service from revaluing a Section 2036(c) situation transfer (i.e., again, determining the transferred property's value at the time of transfer) in connection with the tentative tax computation performed for purposes of computation of a deceased taxpayer's estate tax, unless there has been a prior determination of value after audit by the Service, including under the new review procedure proposed in III.D., below. Moreover, where there has not been a gift tax audit (even if, for example, a taxpayer thought the transfer to be an annual-exclusion gift when made), the tentative estate tax computation will be made pursuant to Section 2001(b)(1), based on the sum of the decedent's *inter-vivos* taxable gifts and the gross estate otherwise reportable at the decedent's death, but without subsequent revision, in connection with the applicable estate tax computation, of valuations in determining the tax on the prior gifts under Section 2001(b)(2).¹² This will increase the tax due at death.

Once the Service has audited a taxpayer's return and has determined a gift-tax value for a Section 2036(c) situation transfer, it is foreclosed from subsequently revaluing the transfer subject to the prior audit, either for gift-tax or for estate-tax purposes.

In addition, if the gift was not properly reported, the Service may adjust the value of the gift on a gift tax audit without regard to the six-year statute of limitations.

Under all circumstances, the offset under Section 2001(b)(2) to the estate tax will include only gift tax actually paid with respect to a Section 2036(c) situation transfer.

4. Undervaluation penalty. The Service may assess a substantial undervaluation penalty comparable to that of Section 6622(g) of the Code, either in a gift tax proceeding or in the estate tax proceeding, if not barred by the statute-of-limitation rules of III.C.2. and III.C.3., above, but not in both such proceedings.

Because the Service has been left with power to redetermine valuation in the estate tax proceeding, even though there may have been full return disclosure of the earlier Section 2036(c) transfer, but no audit, (a) the undervaluation penalty will not apply in the gift tax context after expiration of the gift tax statute of limitations, and (b) in the estate tax proceeding, the burden of proof on valuation will be on the Service if there was prior disclosure of the transfer by the taxpayer. The

¹² In contrast to current Section 2001(b)(2), unless there has been a prior gift-tax audit, the estate will be entitled to an offset of only the gift tax paid, and not the hypothetical gift tax which would have been paid on a proper valuation.

rules as to retrospective use of post-transfer facts with respect to deviation from the valuation tables, described above in III.B.2.a., will apply in the estate tax proceeding. The expanded reporting and disclosure requirements and the lifting of the statute of limitations in the absence of disclosure to the Service will discourage taxpayers from playing audit roulette to avoid tax. Requiring disclosure will give the Service information to curb abuses, but without the changes in substantive rules effected under current Section 2036(c).

D. Taxpayer Request for Review. Because Section 2036(c) situations have historically resulted in transfer tax avoidance abuses, we recommend revision in the manner of applying the statute of limitations and reporting and disclosure rules. These additional tools, combined with the change in valuation standards, are critical to eliminating abuses. At the same time, we feel equally strongly that taxpayers have a right to certainty of the tax results of their transactions. Accordingly, our Proposal provides that a taxpayer with respect to a particular Section 2036(c) situation transfer may request that the Service review the taxpayer's valuation of the property transferred. Such a proceeding will be treated as an audit under III.C., above, to secure the benefits of the statute of limitations for both gift-tax and estate-tax purposes.

A taxpayer may petition the Service at any time following the year of a Section 2036(c) situation transfer to audit the valuation on the transfer. The Service will have until the expiration of the later of either (i) six years after the date of filing of the return reporting the transfer (treating a return filed before its due date as if filed on such due date) or (ii) two years after the date of such request within which to audit the taxpayer's valuation of the transferred property. During such period the gift tax statute of limitations will remain open or may be reopened. The Service will have the opportunity during such period to review post-transfer facts, to determine if assumptions made by the taxpayer (such as, for example, the regular payment of dividends) in determining the reported value of the transferred interest were reasonable. The Service may adjust the valuation where post-transfer actions, within the reasonable control of the taxpayer, are not consistent with the initial assumptions, but unforeseen post-transfer events not within such control of the taxpayer may not be used to alter a taxpayer's initial valuation. If the Service fails to audit after the taxpayer's request, the taxpayer's valuation will be accepted as if audited. The audit will be judicially reviewable as under existing rules for gift taxes. This new procedure will give a taxpayer the opportunity to achieve finality with respect to a Section 2036(c) situation transfer, but only if the Service first has been provided adequate disclosure and an opportunity to audit. Thus, the six-year statute of limitations is an integral corollary to the review procedure.

IV. Comparison of the Provisions of the Proposal with Those of the Discussion Draft

A. Similarities

As we have said, the Discussion Draft is an improvement over current Section 2036(c). Our Proposal has much in common with the Discussion Draft, and, to that extent, it may be regarded as simply an alternative way to achieve the common objective of curbing valuation abuses.

In particular, both our Proposal and the Discussion Draft (i) abandon the troublesome substantive concept of a "disproportionately large" transfer of potential appreciation and the consequent potential for triggering substantive liability by the retention of some esoteric "interest" in an underlying "enterprise"; (ii) abandon the retained life estate model which departs from property law rules to effectively tax a decedent's estate on something the decedent had not owned for many years; (iii) give cash, conventional debt or other consideration the treatment normally accorded it, even among family members, without the complex requirement to test the "cleanliness" of the consideration; and (iv) limit their new approaches to ten-percent owned entities, thereby avoiding an unnecessary broadening of the Section 2036(c) rules. As a result, both our Proposal and the Discussion Draft attempt to avoid the discouragement of current Section 2036(c) to intrafamily transfers and efforts of members of the

younger generation to build up the value of a family business while their parents still are alive.

B. Contrasts

Our approach is both conceptually correct and simpler than that of Discussion Draft. The chief difference between our Proposal and the Discussion Draft is that the latter imposes fictional values on interests involved in a transaction. Because it imposes fictional values on the interests involved in the initial transaction, the Discussion Draft is obliged to provide elaborate rules to trace those interests and make certain they are valued consistently throughout the life of the transferor, as well as at the transferor's death. Those rules, contained in § 2701(d) and (e) of the Discussion Draft, are very complicated, and their application to any but the simplest of paradigm cases is uncertain.

Even though the values imposed on an interest in property by the complicated rules of the Discussion Draft may sometimes be approximately the same as the interest's true value (as critics of valuation abuses might assert), the Discussion Draft's inherent imprecision in this regard is weighted against the taxpayer. Our Proposal, because it focuses on true value, automatically reaches a correct, as well as the desired, result, without such elaborate "consistency" rules. Nor do we place an arbitrary minimum value of twenty percent on the transferred interest, as does the Discussion Draft -- a punitive and harsh result where the transferred interest truly has only nominal value.

As a corollary, the Discussion Draft imposes certain structures -- "qualified fixed payments" -- on taxpayers who desire a satisfactory result, while our Proposal permits parties to choose the structure that best meets their nontax needs and requires only that they value interests accurately *at the time of transfer*. Our Proposal is also preferable in that, by eliminating the traditional minority-interest discount for valuation purposes, it prevents an individual with a majority interest from artificially bifurcating that interest into several "minority" interests with understated values, while, at the same time, recognizing that, if the aggregate family interest in an asset is itself a minority interest, fair market value historically and correctly must reflect a discount.

While our Proposal provides the Service with a final opportunity to detect and correct gift tax valuation abuses, through increases to adjusted taxable gifts under Section 2001(b)(1)(B), without a corresponding gift tax credit offset under Section 2001(b)(2) beyond the gift tax actually paid, this feature operates only to implement the correct valuations *when made*. In our view, one of the most frustrating elements of current Section 2036(c), which is retained in the Discussion Draft, is unavoidable uncertainty. The uncertainty may be caused by a mandated undervaluation of a retained interest that requires compensation at the time of death or by the lack of a procedure to achieve finality of a gift-tax valuation. Our Proposal avoids that frustration by providing a structure of clear rules and consistently accurate valuations. Our Proposal also affords taxpayers an opportunity to obtain certainty with respect to Section 2036(c) Situation transfers by permitting them to file with the Service a request for review, albeit at the possible cost to a taxpayer of extending or reopening the gift tax statute of limitations.

V. Conclusion

Our concern is in providing an appropriate alternative to Section 2036(c) that addresses the legitimate valuation concerns of the Congress and the Treasury while, at the same time, providing taxpayers with a measure of finality. It is precisely the measure of finality provided by our Proposal that commends its consideration as an alternative to the Discussion Draft, which we believe suffers from a lack of certainty similar to that inherent in Section 2036(c). In addition, in contrast with both the Discussion Draft and current Section 2036(c), our Proposal does not have the potential for penalizing nonabusive transactions between or among family members. Moreover, we believe that our Proposal sets out a more realistic approach to valuation than does the Discussion Draft, which, in general, except for the narrowly

defined concept of "qualified fixed payments," provides that intrafamily retained interests are to be valued at zero.

We believe that the changes to pre-OBRA 87 law contained in our Proposal will be sufficient to impose taxation based on appropriate and traditional legal concepts of property and tax law, while, at the same time, eliminating the procedural and audit advantages that taxpayers have had over the Service. Accordingly, our Proposal replaces Section 2036(c) with a statutory scheme that remedies the perceived abuses at which Section 2036(c) was aimed and yet avoids complex and novel legal concepts at odds with normal business practices.

Mr. LEVIN. Mr. Dees.

STATEMENT OF RICHARD L. DEES, ESQ., PARTNER, McDERMOTT, WILL & EMERY, CHICAGO, IL

Mr. DEES. Thank you, Mr. Chairman.

My name is Richard L. Dees, and I am a partner in the Chicago office of the national law firm of McDermott, Will & Emery. In May 1989, I was an invited witness to the Senate Finance Committee on why current section 2036(c) should be repealed.

Since that time, I have given technical advice to members of the Business Coalition to Repeal Section 2036(c) and was named as a technical expert by the National Grocers Association and the Small Business Legislative Council to work with Treasury on a replacement to section 2036(c). My comments today, however, are my own and not necessarily those of the NGA, the SBLC, of any other business group or those of any firm client.

I am grateful for the opportunity to submit nine pages of technical comments about the proposal and to summarize those comments here today.

The structure of the proposal, in my view, is an acceptable path out of the 2036(c) quagmire. All of my comments suggest a continuation along this same path, not a departure from that path. We should continue to narrow the proposal. The proposal should be made even more fair to family business owners. To the extent consistent with the first two objectives, the proposal should be made simpler.

We already see the current statute narrowed in two more respects. Gone are the concepts of disproportionate appreciation and enterprise, which proved unworkable, and which are really an attack on family cooperation.

Finally, we see a severance of the "strings" approach in 2036(c). It is that strings approach that resulted in the attack on the continuation of parents in the family business if they wish only to reduce their involvement that was described by Mr. Zaucha.

The changes in the proposal which are needed to make it acceptable are not intended to open the door to abuse. There is a discipline to this process that everyone must recognize. If the replacement ultimately adopted allowed abuses to continue, then undoubtedly we will be back here next year facing a reenactment of 2036(c).

If the statute continues to impact 100 percent of all family businesses and not just 5 percent who actually do freezes, then there will be others here next year urging a repeal of chapter 14.

This ought to be a simple litmus test to apply to whatever proposal is ultimately adopted by this committee and the Congress. We have succeeded in narrowing the proposal only if the 5 percent who actually do preferred stock freezes—the abuses that were designated in the enactment of 2036(c)—are the only ones who have to read chapter 14.

This is not the case presently in the proposal. Every family business owner will have to read and understand chapter 14 to see if there is some unexpected application. The reason is the same as that which I outlined in my testimony to the Senate Finance Com-

mittee. That is because this statute, like current section 2036(c), continues to try to define the abuses in the same way that I would try to tell someone how to get to my house by telling them everywhere in America I don't live. We should identify the abuses, hit those and leave the broad range of statutory applications out.

I want to suggest that there are many—18 or 20 ways—that we can improve the existing statute. First is to make the proposal narrower by not making it apply to buy-sell agreements, leases and debts, employment agreements and similar business arrangements.

Unlike the Bar Association panel, I am not convinced that the statute was intended to apply to leases and debts in the way they suggest. The proposal seems to indirectly apply to that, and it may be just like the human appendix, an undeveloped evolutionary track that is saved for the future.

I think that the proposal should only apply to the valuation of frozen equity interests, that is, stock or a partnership interest with a fixed value on conversion. That will do a great deal to limit the application of the statute.

It should not apply to publicly traded securities and should not apply unless the corporation is actually controlled by the transferor, a 50-percent test and the proposal currently values too many discretionary rights, zero. This will have to change.

The proposal is unfair primarily in a couple of ways. First of all, it discards the valuation rules when it benefits the taxpayers, but not the IRS. Second, it imposes a gift and estate tax on the same transaction—a continuation of current 2036(c). Finally, it applies to stock—going beyond the existing statute—held by family members that is frozen. And it continues, unlike the gift rule under 2036(c), even when the gifted stock has been given away.

We also view as unfair the in-effect transfer rules and recommend you study the Chamber of Commerce proposal which revises that rule and incorporates it into section 2701. We also see a need for changes to increase the flexibility of family businesses to endure economic downturns by expanding the exceptions and allowing some flexibility in that regard.

I also want to mention the liquidation rules, which allow the IRS to value the preferred and common differently, thereby inflating the value of the common. Thank you.

[The statement of Mr. Dees follows:]

Prepared Statement of
Richard L. Dees
McDermott, Will & Emery
Chicago, Illinois

Testimony Presented April 24, 1990
Public Hearings of
The Committee on Ways and Means

Hearing On Discussion Draft to Modify Section 2036(c)

STATEMENT ON TECHNICAL ASPECTS OF THE SECTION 2036(C) PROPOSAL

My name is Richard L. Dees, and I am a partner in the Chicago office of the national law firm of McDermott, Will & Emery. In May 1989 I was an invited witness to the Senate Finance Committee on why current Section 2036(c) should be repealed. Since that time I have given technical advice to members of the Business Coalition to Repeal Section 2036(c) and was named as a technical expert by the National Grocers Association and the Small Business Legislative Council to work with Treasury on a replacement to Section 2036(c). My comments today, however, are my own and not necessarily those of the NGA, the SBLC, of any other business group or those of any firm client.

The Section 2036(c) Abuse. Of the 27 transactions to which the Committee Reports stated Section 2036(c) was to apply, 24 involved the following prototypical "freeze." A wholly owned corporation or partnership is recapitalized into two classes of stock or partnership interests: a preferred class which had a preference for dividend or income payments and on liquidation and a common class which was junior, but had a right to appreciation over the stated value ("frozen value") of the preferred. The owner then gave away the common while retaining the preferred. The dividends or other payments on the preferred may never have been paid, but the value of the preferred was artificially supported by a redemption right, a conversion right or a power to liquidate. These rights were never actually exercised so that over time the value of the preferred was frozen at its initial stated value. Moreover, the unpaid dividends or income payments accumulated in the entity to the benefit of the common owners. Using time value of money concepts, if the payments were deferred into perpetuity, their present value approached zero. The actual present value was never that low as the life expectancy of the parent was often short and the frozen value of the preferred would be taxed in the parent's estate.

Thus the Section 2036(c) "abuse" involved four elements all of which were necessary: (1) preferred stock held by a parent with a fixed or "frozen" value, (2) the use of unexercised conversion, redemption or liquidation rights to artificially support the preferred's fixed value, (3) the failure to make the expected dividend or other payments on the preferred, (4) which accrued to the benefit of the children who held the gifted common.

Drafting a replacement to current Section 2036(c) means targeting the elimination of the abuse without discriminating against family businesses. That is a delicate balance, but one which it should be possible to achieve. The Proposal is an acceptable starting point for such a replacement. We therefore appreciate the efforts of the drafters of the statutory language and this Committee for holding hearings on that language. Working together we can develop an acceptable replacement.

The Proposal. The Proposal targets the abuse by --

1. Specifying that preferred stock (or partnership and trust interests) will be valued by assuming that all stated quantifiable payments ("QFP's" in the statutory vernacular) will be made
2. That all other retained rights will be valued at zero, subject to a few limited exceptions (hereafter "non-discretionary rights")
3. Providing (subject to certain exceptions) that a deemed gift will result if the stated payments, in fact, are not made

General Concepts. While these elements of the Proposal are acceptable, in other respects the Proposal is an unacceptable replacement for Section 2036(c).

First, the Proposal is overly-broad. Probably less than 5% of all family business owners and farmers engaged in preferred stock freezes, yet Section 2036(c) impacted 100% of those owners and farmers. The replacement must not apply to the 95%. In my testimony to the Senate Finance Committee I compared Section 2036(c) with trying to give directions to my house by describing everywhere in America I don't live. The Proposal has a similar flaw. It is drafted so broadly out of a concern that some tax savings device may not be caught. The result is an unnecessarily complicated statute which needlessly impacts business transactions. It is important to return to the notion of targeting the abuse and relying on regulations and the courts to end schemes which are designed to avoid the statute. Specifically:

1. The Proposal should not apply to buy-sell agreements, leases, debt, employment agreements and other business arrangements.
2. The Proposal should apply only to the valuation of "frozen" equity interests, i.e. stock or a partnership interest with a fixed value on conversion, redemption or liquidation.
3. The Proposal should not apply to trusts. Its inclusion in this section makes the Proposal unnecessarily complex.
4. The Proposal should not apply to frozen interests held by someone other than the transferor or his or her spouse.
5. The Proposal should not apply in non-family situations. The Proposal should not require deemed gift treatment when a non-family member benefits from the passed dividend.
6. The Proposal should not require the valuation of the entity.
7. The Proposal should not apply to publicly traded securities.
8. The Proposal should not apply unless the transferor and family control the entity. With spousal attribution that should be 50% control.
9. The Proposal values at zero too many rights which are not discretionary.

Second, the Proposal is unfair. Unfairness is present in several respects. Specifically:

1. The Proposal disadvantages owners of family businesses and farms as compared with investors and public and foreign corporations.
2. The Proposal imposes no discipline on the IRS because it disregards the neutral valuation principles it purports to apply when those principles would benefit taxpayers.

3. The Proposal imposes both a gift and an estate tax on the same transaction.
4. The Proposal unfairly applies to preferred stock held by family members of the transferor. Current Section 2036(c) does not go so far as to apply to frozen interests held by someone other than the transferor or his or her spouse. One of the common uses of preferred stock in a family business is to give inactive children preferred stock and active children common stock. This provision gives the inactive children a veto over the gifts of common by the parents.
5. The Proposal unfairly allows the IRS to use different valuation approaches to value the preferred and common, thereby inflating the value of the common.
6. Although the Proposal goes a long way towards permitting business flexibility by allowing a three year grace period for dividend payments and an insolvency exception, further relief is desirable.
7. The Proposal could result in the value of the preferred exceeding the value of the business.
8. The Proposal should apply prospectively only and a generous transition period should be allowed for business owners and their advisers to adjust to these new rules.

Finally, the Proposal is too complex. The purpose of Chapter 14 is to impose a gift when ordinary valuation principles would say that no gift occurred. Accordingly, the rules should be designed to mitigate any harm caused by this element of surprise. Another element of simplification is to cast the statute in terms of concepts which business owners and their tax advisers understand. Specifically:

1. The Proposal continues one of the discredited aspects of current Section 2036(c): the notion of "in effect" transfers. The concept is mathematically impossible to apply, and yet the Proposal would extend this unworkable concept to all of the transfer tax.
2. The Proposal generally requires timely elections. The federal fisc will not be harmed by late elections as long as those elections are consistent with the taxpayer's prior actions.
3. The Proposal would be simpler and easier to understand if it adopted other tax concepts, e.g. entities taxed under subchapters C or K (in lieu of partnership and corporation) and attribution rules from Section 318(a)(2).

Specific Comments. The section by section comments which follow expand on these general comments above as they relate to partnerships and corporations. My comments on the trust aspects are that they do not belong in Section 2701 and that the problems of GRITS and their progeny require separate treatment. The final section of this testimony describes that treatment.

Section 2701(a). This statement of the general rule contains a number of initial missteps:

1. It adopts an entity approach that increases complexity and requires the valuation of the entire business.
2. It speaks of valuing rights rather than valuing stock and partnership interests. This conveys the false notion that rights in

a partnership or corporation can be conveyed without the conveyance of the underlying stock or partnership interests.

3. The retained rights ("interests" are used interchangeably in some cases) which are specially valued needs to be limited to those right associated with stock or partnership interests which have a frozen value. Unless the appreciation rights have been severed from the capital rights no "freeze" has occurred. Likewise the failure to make the required payments accrues to the benefit of the preferred holder. Unless this change is made, impossible mathematical problems arise on allocating the benefit from the failure to make the required payments.
4. The special valuation rules should apply:
 - a. To gifts of junior equity interests to family members as currently provided
 - b. To the exchange of property for frozen equity interests which have a special value less than the fair market value of the property exchanged which would be a pro rata gift to the holders of the junior equity interests which are family members of the transferor
 - c. To gifts of frozen equity interests to a family member other than the spouse
 - d. To the disposition of a specially valued frozen interest to anyone
 - e. To the estate tax inclusion of a specially valued frozen interest

The purpose of this expansion would be to ensure that the neutral valuation rules applied in all instances equally to the Treasury and taxpayers. It would eliminate the necessity of those portions of the Proposal which allows both a gift and estate tax to be imposed on the same transaction. It would also eliminate the unfairness inherent in taxing the appreciation in the value of retained rights without any offset for depreciation. Finally, it would remove any need for the "in effect" transfer rule.

Section 2701(a)(2)(A). This section should provide that discretionary rights associated with the frozen equity interests should be valued at zero. The term "discretionary rights" should be limited to discretionary rights with respect to conversion, liquidation, put or call and dividend and other discretionary payments. QFP's can continue to be defined as in the Proposal.

Section 2701(a)(2)(C). The lead-in should be revised to clarify:

For purposes of determining the value of the right to receive qualified fixed payments under any instrument, *the value shall be determined by discounting such payments employing the following assumptions:*

Section 2701(a)(2)(C). This laundry list of rights which are not impacted by the valuation rules under Chapter 14 needs to be expanded.

1. It is practically impossible to assign a value to voting rights. Moreover, in the context of preferred stock voting rights were traditionally used to artificially support the value of the

preferred without paying dividends. It would be preferable to state that Chapter 14 does not impact any discount for minority interest or lack of marketability of the transferred interest.

2. The phrasing of "any instrument none of the rights under which have a preference over any rights under the transferred interest" unintentionally catches gifts of non-voting common which was not caught by Section 2036(c). The entire section should refer to rights in the retained preferred which are not preferred over rights in the transferred junior equity.
3. Additional rights need to be included in this laundry list:
 - a. Option and buy-sell rights which meet the requirements of Treasury Regulation §20.2031-2(h).
 - b. Employment agreements, debt and leases.
 - c. Other non-discretionary rights such as those tied to objective factors, such as CPI, sales, production, and all other rights not specifically defined as discretionary rights.

Section 2701(a)(3). This section limits the value of the common to no less than 20% of the value of all equity interests in the entity combined with all family debt. This rule is arbitrary and without merit. Although the stated purpose of the replacement is to tax 100% of a business in the transferor's transfer tax base, this rule actually taxes 120% of the business in that base. This rule further discriminates against family businesses in favor of an investor with cash who could lend 100% to a child to purchase a family business while the business owner can provide only 80% of the capital to his child. In many family businesses it will force the family to borrow from a bank rather than from the family. The 1988 act eliminated that discrimination from current Section 2036(c).

Section 2701(b)(1)(C). Would be better understood if stated as *an amount which lapses on the death of an individual.*

Section 2701(b)(3). By requiring a family member of the transferor to elect treatment of his interests as a QFP in order to value those interests at other than zero the non-active sibling who holds preferred stock is given a veto over gifts of common to the active sibling. In fact, this rule goes further than current Section 2036(c) which uses the proportionality rule to result in taxing only the transferor on appreciation rights he transferred while retaining the frozen rights. The replacement taxes the transfer of appreciation rights where the frozen rights are owned by someone else. This is an unacceptable result.

Section 2701(b). An additional section should be added allowing non-family members to value their gifts of common consistently with the provisions of subsection (a) without electing deemed gift treatment. This would simplify valuations for both taxpayers and the IRS if it was known that the Chapter 14 valuation approach was a safe harbor.

Section 2701(b)(4)(B). As currently proposed, this section would preclude any ability to assign value to the underlying capital value of a stock or other payments from a partnership which might be discretionary (say a distribution within the discretion of a general partner) but likely to be paid. The section should allow any presumed amount and payment dates *which are not inconsistent* with the terms of the instrument.

Section 2701(b)(4)(C). The requirement that the non-QFP election must be made on timely filed gift tax return is unnecessary as long as the election if made on a late filed return must also be consistent with the actual payments made.

Section 2701(c)(2). An additional requirement should be added to the application of the deemed gift rule that the transferred interest is still held by a family member of the transferor other than his or her spouse.

Section 2701(c)(2)(B). There is no reason to limit the rule to interest payments. As long as any passed payments compound in the transferor's estate, no deemed gift should result. The rate of compounding could be either the initial market testing rate or the market testing rate for the period.

Section 2701(c)(5)&(d)&(e). These sections would be substantially rewritten so that a single valuation rule for preferred would apply in all circumstances. This would preclude the unfairness in the Proposal that the Treasury can tax all upward appreciation from retained interests, and that as under current Section 2036(c) both a gift and estate tax is imposed on the same property. This "heads we win, tails you lose" approach also encourages an overly broad statute as the Treasury has no incentive to draw objective, fair valuation rules. The existing statute needs to be clarified:

1. The current unity rule would have to be continued, but it should be clarified that the preferred passing to the surviving spouse at death receives a basis step-up.
2. The Proposal also needs clarification that the special value attributable to the preferred in excess of fair market value which is includible in the estate is part of the basis of the preferred.
3. Treating terminations as transfers serves no purpose in the Proposal.
4. The Proposal should exempt the exercise or non-exercise of discretionary rights valued at zero from the transfer tax.

Section 2701(f). The statute should be clarified so that no payments would become due during the period of insolvency rather than merely delaying the 3 year period for payment. It is important to allow other hardship exceptions to deemed gift treatment. One improvement would be to allow relief when the earnings and profits or book income (adding back payments to family members) drops significantly from the adjusted earnings and profits on the date of the recapitalization or under the payments would exceed such amount. One concern has been that the business owner would set the dividend rate so high to avoid an initial gift that the rate itself would create hardship in paying future dividends. This objective computation would prevent this abuse. Another possibility is to allow application to the Treasury for an exception. Treasury could then adopt objective rules for determining when to grant relief. This would be modeled after the current hardship exception for funding defined benefit plans.

Section 2702. This section of the Proposal deals specifically with buy-sell agreements. It is unnecessary in light of Treasury Regulations §20.2031-2(h) and the reported cases which set forth rules which appropriately balances the legitimate business objectives of family business owners against the needs of the federal fisc. The regulation provides:

the option or contract price, . . . will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

The Regulation permits Treasury to ignore options in buy-sells which have an estate planning motive rather than a business motive. For example, the courts have backed Treasury when it ignored an option formula which produced a \$0 value. It is not

true as frequently suggested that the cases uphold every buy-sell agreement as having a business motive.

The tax court memorandum decision in Seltzer Estate is sometimes cited as a decision which demonstrates the estate planning potential in current law because the price was tied to book value without regard to goodwill. While it is true that the sales price in the buy-sell was less than the sales price which might be obtained without the agreement, the price was not motivated by estate planning. First, the sale to the corporation benefitted not only family members but non-family members. The proposed Section 2702 gives no guidance as to how to sort out family member and non-family member rights when the corporation has the right to purchase. Second, the agreement permitted only directors and employees to own stock. Thus the decedent's family was limited in its ability to continue ownership of the stock. Finally, the agreement bound all shareholders equally both during life and at death. The presence of non-family members again demonstrates the arms-length nature of the agreement.

Section 2702 goes too far when it also ignores rights of first refusal and leases in determining value for transfer tax purposes. Rights of first refusal and other transfer restrictions are always present in privately-held businesses. These rights do not fix value for estate tax purposes so that there is no "freeze" potential. However, like other aspects of ownership of stock in a private business, such as SEC restrictions, minority voting and lack of marketability, these restrictions depress value. It is discriminatory to ignore the value depressant effect of these rights when held by close family members, but to recognize that effect when held by others.

Section 2703(a)(2). This section which applies Section 2701 to non-family members needs to be eliminated. Apply the family member definitions is difficult when the transferee is not a family member. This rule goes further than current Section 2036(c) as interpreted by Notice 89-99. This rule will continue the use of so-called "bells and whistles" in non-family situations. There should be no reason to resort to pre-Section 2036(c) rules in this context.

Section 2703(b). For more certainty, it would be desirable to adopt the Section 318(a)(2) attribution rules.

Section 2703(c). As under current Section 2036(c), this concept is impossible to apply mathematically, may lead to the application of this section to redemptions for cash and is otherwise meaningless. The concept should be replaced by a rule under Section 2701 that an exchange of property for a frozen interest will result in a gift to the junior equity holders to the extent the value of the property exchanged exceeds the special value of the frozen interest. Extending the rule to Chapters 11, 12 and 13 is clearly not justified.

Section 2703(e)(1). This section defining the entities to which Section 2701 applies needs to be substantially rewritten:

1. Unlike current Section 2036(c) this section applies sibling attribution. Accordingly, the percentage test should be raised to 50% so that it applies only when a family has actual control of a corporation. Moreover, the test should be applied only as to control not capital or income.
2. Section 2701 should not apply when the securities are publicly-traded.

Section 2703(e)(3). This provision which treats leases and debt as equity interests (and corresponding provisions in other parts of the statute, such as the inclusion of indebtedness in the computation of the 80/20 rule and the application of the trust entity rule to debt and lease payments) should be removed from the Proposal. Section 2703(e)(3) is particularly hard to understand. It appears to favor taxpayers because it allows debt and lease payments to reduce the value of the entity without requiring a gross up in value for the indebtedness (except for purposes of the 80/20 rule). If that is the implicit result, then why is the result

explicit for debt under the 80/20 rule and for leases under Section 2702? The only conclusion is that the section, like the human appendix, must represent an undeveloped evolutionary track. It is simply impossible to rationalize with the rest of the statutory language.

Section 2703-Additional Special Rules.

1. The specially valued preferred should not exceed the value of the business.
2. In family businesses with low cash flow, such as a farm, the IRS argues that the business should be valued at its liquidation value rather than its going concern value. Of course, this results in a higher value for the business. The Proposal mandates a cash flow or going concern approach for valuing the preferred stock. The IRS should not be permitted to value the business using a liquidation approach and then mandate the valuation of the preferred at cash flow value when its liquidation value is much higher.
3. The Proposal should specify a market testing rate of 66% or less of the applicable federal rate ("AFR"). The assumption is that the QFP's will be paid. This eliminates any need for a higher rate to account for risk, dividend coverage, or lack of marketability. The AFR represents a safe taxable rate of return. A rate higher than AFR would discriminate against family businesses in favor of investors. A wealthy individual can loan cash to a child to buy a business (or growth stock) and need only receive interest at the AFR. The non-deductibility of dividend payments also justifies a lower rate. "Blue Chip" corporate preferred stock often carries a rate lower than AFR.

Gift Tax Changes. The special targeting of business transactions for changes in the statute of limitations for gift tax purposes is inappropriate considering the adoption of objective valuation rules. The tightening of gift tax reporting was suggested in lieu of valuation changes. Additional gift tax changes, therefore, are duplicative and unfair discrimination. However, it is important to change the existing situation where gift tax returns essentially are meaningless. The current IRS practice encourages games-playing by taxpayers and over-reaction by the IRS. The most effective means to change the current situation is to allow taxpayers to waive the use of the unified credit and to clarify existing law that paying a gift tax or waiving the use of the credit would fix values once the assessment period expired. Statutory language to accomplish this change is attached.

Revenue Issues. The Proposal should raise tremendous revenue over the next 5 years. First, there will be no more freezes! The retained interest in the estate will grow in value at the "market testing rate." Second, Proposal will force business owners to pay dividends subject to double taxation on preferred stock. Third, businesses issuing preferred stock will not be able to take advantage of the Subchapter S rules. Fourth, gift tax revenues will increase due to the annual gift tax treatment of passed dividends and the discounting of the preferred stock. Fifth, allowing the waiver of the use of the unified credit will raise additional revenue and will increase the number of gift tax audits.

GRIT's and Other Trusts. GRIT's and other trust devices present different issues than the valuation of frozen equity interests. It would be illogical to mix the two concepts in the Proposal. GRIT's are an anomaly of the rates employed in the Treasury Tables and the method required thereunder for the valuation of the gifted portion. The IRS has long misvalued GRIT's and similar devices. This misvaluation and the safe harbor in Section 2036(c) for certain statutory GRIT's is the sole reason for the current popularity of these devices. If valued properly, GRIT's offer no advantage over other types of gifts.

A GRIT is an immediate irrevocable gift of a remainder interest in a trust. The remainder interest vests in fee at the end of a specified term of years during which the grantor/donor retains the income. Long ago, the IRS adopted an "easy to complete" rule which held that a gift to a GRIT or other trust would be deemed a gift of the donor's entire interest, except to the extent that the donor's retained interests were susceptible to valuation. Accordingly, the IRS requires that the gift portion of a GRIT be determined by subtracting the value of the donor's retained income interests from the value of the property transferred to the GRIT.

GRIT's can be used to reduce estate taxes because the 1988 tax act established a floating discount rate that overvalues the retained income interest by at least 20% (the discount rate is set at 120% of the applicable federal rate). This discount is a taxable rate of return. A taxable rate of return is an acceptable benchmark as a substitute for a taxable interest rate. It also is an acceptable discount for valuing income interests and annuities which are substitutes for taxable income. However, it is not an acceptable rate for valuing remainder interests. An after-tax or tax-free rate should be used.

The IRS subtractive approach obscures this distinction between the valuation of the income and remainder interests. The distinction meant very little when the discount rate was 3% at the inception of this approach, but is significant now as the discount rate is 10%. The real value of the remainder is the amount which must be invested now at the discount rate to produce a value at the end of the term equal to the present value of the property gifted to the GRIT. This is why the discount rate should reflect a tax-free or after-tax rate of return. Thus the discount rate should be 72% of the applicable federal rate, not 120%. (The 72% reflects a reduction by the 28% top federal rate. An alternative rate would be an average of tax-exempt rates.)

Of course, the actual value of the property at the end of the term might be higher or lower than the present value of the gifted property. This would be true if the donor had made an outright gift of cash equal to the discounted present value which the donee then invested for the term. Similarly, actual income payments to the donor may be more or less than the discounted value of the income interest. This would be true if the donor retained cash equal to the discounted value of the income interests. The problems with Section 2036(c) proves that gift tax value should not depend on the appreciation of the gifted property.

The retention of a reversion to further reduce the value of the GRIT also has drawn criticism. The need for the reversion is based solely on an inconsistency between the gift and estate tax rules applicable to GRIT's. If the grantor dies during the term, the entire GRIT, even the remainder previously subject to gift tax, is subjected to estate tax. The reversion mitigates this double taxation by excluding from the gift tax the value attributable to the possibility of dying early. Again, if the reversion is valued properly, no abuse occurs.

If this bifurcated discount rate is used, GRIT's would be valued properly and no further changes in tax treatment would be warranted. In addition, the generation-skipping tax and estate tax rules should be unified by repealing Section 2036(a) and making the allocation of the GST exemption effective. The alternative method of unifying the transfer tax system, the adoption of a hard to complete rule, would lose revenue and be inconsistent with property law concepts and 40 years of tax law.

APPENDIX

SEC. 2505. STRENGTHEN IRS ENFORCEMENT OF GIFT TAX.

(a) Allowance of Adjustments to Taxable Gifts in Subsequent Estate or Gift Tax Returns.—Section 2504(c) (relating to the valuation of certain gifts for preceding calendar periods) is amended to read as follows:

“(c) Valuation of Certain Gifts for Preceding Calendar Periods. —

“(1) In General.—If the time has expired within which a tax may be assessed under this chapter or under corresponding provisions of prior laws on the transfer of property by gift made during a preceding calendar period, as defined in section 2502(b), and if a tax under this chapter or under corresponding provisions of prior laws has been assessed or paid or the election provided in section 2505(e)(1) (relating to the waiver of the unified credit) has been made for such period, the value of such gift made in such preceding calendar period shall, for purposes of computing the gift tax under this chapter for any calendar year or the estate tax under chapter 11, be the value of such gift which was used in computing the tax for the last preceding calendar period for which a tax under this chapter or under corresponding provisions of prior laws was assessed or paid or the election under section 2505(e)(1) was made.

“(2) Effect of Gift Value Adjustment.—If paragraph (1) does not apply to a preceding calendar period for which the election provided in section 2505(e)(1) could have been made and if the value of a gift made during that period is increased for purposes of computing the tax under this chapter for any subsequent calendar year or the tax under chapter 11 on the taxable estate of the donor, such increase shall be considered a gift of a future interest in property made during the subsequent calendar period or, if the increase in value was for purposes of computing the tax under chapter 11, an increase in the taxable estate of the donor.”

(b) Waiver of Unified Credit.—Section 2505 (relating to the unified credit against gift tax) is amended by adding new subsection (e) at the end thereof to read as follows:

“(e) Waiver.—

“(1) In General.—An individual may elect with respect to any calendar period to waive the use of any credit otherwise allowable under this section to reduce any deficiency of tax for such period, regardless of whether the sum of the amounts allowable as a credit to the individual under this section for all preceding calendar periods is less than the maximum amount allowable as a credit under this section.

“(2) Effect of Waiver.—If the individual makes the election referred to in paragraph (1),

“(A) The amount allowable to an individual as a credit under this section for the calendar period shall not exceed the amount of the credit claimed on the gift tax return for such period; and

“(B) For purposes of determining any deficiency of tax attributable to an increase in the value of any transfer made during the calendar period for which such election is made, the aggregate sum of the taxable gifts for each of the preceding calendar periods for purposes of section 2502(a) shall not be less than \$600,000.

“(3) Election.—The election under paragraph (1) shall be made on a timely filed gift tax return and, once made, shall be irrevocable unless the Secretary consents to revocation.

“(4) Regulations.—The Secretary is authorized to promulgate regulations concerning the manner of making the election referred to in paragraph (1).”

(c) Effective Date.—This section shall apply to gift tax returns for calendar years beginning with 1990.

Mr. LEVIN. Mr. Aucutt.

STATEMENT OF RONALD D. AUCUTT, ESQ., MILLER & CHEVALIER, WASHINGTON, DC.

Mr. AUCUTT. Thank you.

My name is Ronald Aucutt, a member of the law firm of Miller & Chevalier, Chartered. I appear before the committee today in my individual capacity. I would like to join the many who have commended the committee and its staff for the process that has brought us to this point.

There were lots of problems with section 2036(c) and a number of members of my profession said so. This committee heard us and has now expressed its willingness to consider a new approach. That not only affirms the democratic process, but guarantees a better result when this type of process proceeds as it has in dialogue with professionals and professional groups and with taxpayers.

The discussion draft does take the right approach. The objective is proper valuation in a transaction. The objective of many of the other proposals that have been explained to this committee today are also proper valuation. That is the right approach.

I only know one way to evaluate the discussion draft or some of these other proposals like the ABA, ACTEC proposal or the District of Columbia Bar Taxation Section proposal, and that is by practical experience. There is no question, Mr. Chairman, that many families in restructuring the capital of their businesses want to get values right, want to do a good job and really try to get the values right, and my question, which I apply to something like the discussion draft, is: Will those people be impeded unduly in doing what legitimately they ought to be entitled to do?

My answer to that question is, that they will not. Under section 2036(c), it was almost impossible to do the legitimate kinds of restructuring that I have in mind. Under the discussion draft, it is true that many families who want to do these kinds of restructurings will have to make some changes, some modifications in their plan in order to avoid undue problems with the statute.

But under section 2036(c), Mr. Chairman, the only change a person could make to a transaction would be to abandon it altogether, because the statute had that kind of limiting effect on the transactions.

The discussion draft, because its approach is proper valuation up front, avoids that problem. These problems and concerns are elaborated in my written statement.

I would like to, at this point, leave the committee with two points: First, many, many of these proposals, as I have said, are, like the discussion draft, based on the objective of arriving at the proper valuations up front. There are lots and lots of differences, and many of these differences are important, but I submit that there is a much more striking consensus among all these alternatives and apparently competing proposals that a valuation up front approach is the right approach, and this consensus is much more striking than many of the differences.

There are anomalies, to be sure, even in the discussion draft. Technical problems, substantive problems. Many of the other wit-

nesses have suggested some of these, but the approach of getting value right up front is the right approach to take.

Therefore, I recommend that this committee continue to work toward an up-front valuation approach that solves these problems and avoids the horrendous difficulties exemplified by section 2036(c). In this process, I recommend that the committee continue, as it has, to view the discussion draft as a discussion draft, open to revision and refinement and improvement as concerns and anomalies are brought to the committee's attention.

And also as a discussion draft, proceeding in dialogue with the professionals and professional groups that have expressed willingness to help. There has been that kind of dialogue. It has been good. It has brought us to this point. Again, I commend that process, and I thank the committee for this opportunity.

Mr. LEVIN. Thank you, Mr. Aucutt.

[The statement of Mr. Aucutt follows:]

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

HEARING ON ESTATE VALUATION FREEZES

April 24, 1990

STATEMENT OF
RONALD D. AUCUTT
MILLER & CHEVALIER, CHARTERED
WASHINGTON, D. C.

Good morning, Mr. Chairman and Members of the Committee. My name is Ronald D. Aucutt. I am a member of the law firm of Miller & Chevalier, Chartered, in Washington, D. C., engaged in the private practice of law, concentrating on estate and gift taxation and estate planning. I appear before the Committee today in my individual capacity.

Commendation of the Committee's Procedure

First of all, I commend the Committee and its Chairman for scheduling this hearing and for giving this subject such careful consideration.

In 1987, Congress enacted section 2036(c) of the Internal Revenue Code, a provision which most members of my profession found overly broad and unworkable. Many of us said so. In 1988, Congress substantially revised the statute. These revisions addressed some of our concerns, but raised many more. Many of us still found the statute to be unworkable, and again we said so.

The "Discussion Draft" the Chairman released on March 22, 1990, represents an approach to the issue of estate freezes that is fundamentally different from the approach of section 2036(c). By its willingness to abandon a troublesome approach and start over again, the Committee demonstrates its receptivity to and respect for the views of those of us who have criticized section 2036(c). Members of my profession should be pleased. I am.

Basic Approach of the Discussion Draft

The Discussion Draft takes a basic approach that is commonly described as a "front-end valuation" approach. In other words, the focus of the Discussion Draft is on the provision of rules for valuing property and interests in property involved in a transaction, to determine whether the transaction involves a gift and, if so, the amount of the gift. This is the correct approach and is vastly superior to the approach of section 2036(c), which effectively treats every transfer within its scope as incomplete until the transferor's death. The difficulty with the approach of section 2036(c) is that it departs so dramatically from the laws of property and ultimately taxes persons (and their estates) on what they do not have. The American public is not ready to accept that.

Section 2036(c) is activated by a person's transfer of "property having a disproportionately large share of the potential appreciation in such person's interest" in the underlying "enterprise" "while retaining an interest in the income of, or rights in, the enterprise."¹ Experience with the statute has taught us that this test is impossible to understand or apply. As a result, the statute leaves a person

¹ Section 2036(c)(1)(B).

in suspense for a lifetime. In contrast, a front-end valuation approach, properly designed, will permit some certainty and repose. As I read the articulation of this approach in the Discussion Draft, it prevents an inadvertent tripping of the statute, with possibly catastrophic results, by some forgotten insignificant or esoteric "retained interest." The Discussion Draft takes aim not at all retained interests, but only at certain types of retained interests that the transferor or the transferor's advisors or appraisers choose to take into account in determining the value of a transferred interest. Taxpayers should be able to understand and cope with an approach like that.

It is true that section 2036(c) has been explained with reference to not only valuation abuses in an initial transfer, but also non-arm's-length subsequent conduct and the testamentary nature of a transfer in which "enjoyment" is arguably retained.² In contrast to the fatalistic response of section 2036(c), however, the Discussion Draft contains rules for policing subsequent conduct directly.³ Furthermore, I submit that there is no compelling reason to treat "enjoyment" in any way other than the way property law treats it, other than the suspicion that this "enjoyment" permits subsequent manipulation of values. By policing subsequent conduct directly, the Discussion Draft accomplishes all of the objectives section 2036(c) has been thought to accomplish, but without the anguish that the suspense approach of section 2036(c) makes inevitable.

Assessment of the Effectiveness of the Discussion Draft

The only test I know to ultimately evaluate the effectiveness of a statute like the Discussion Draft, or section 2036(c), is the test of practical experience. I must ask whether the statute permits unhindered the transactions I am aware of or might conceive of where the parties really try to use proper valuations — transactions, in other words, that deserve to escape — and prevents or penalizes transactions I am aware of or might conceive of where the parties are really trying to "get away with something" at the expense of more forthcoming taxpayers — transactions, in other words, that deserve to be clobbered. Under that test, section 2036(c), with its quixotic refusal to let any transaction be final, fails badly. The Discussion Draft, although it does not get an A-plus, scores at least a B. Recognizing that there are no A-pluses in a world as subjective and imprecise as the world of valuation, I can be satisfied with that.

I have maintained that a statute that pretends to trap "value" in a generation like a genie in a bottle or so intrudes into intrafamily relationships as to tax the very "stuff of family" is doomed.⁴ Congress must accept the fact that some "value" will leak through the transfer tax system. As a logical corollary, however, it seems fair to me that taxpayers must accept the consequences of imprecision in the other direction. There will very likely be times when a transaction is impeded by a statute even when no one would find an abuse, and when a taxpayer must therefore organize a transaction or activity in a way somewhat different from what natural instincts would suggest, simply to avoid an untoward result under the statute. The objective, it seems to me, should be to achieve a proper balance. In general, the Discussion Draft achieves that balance.

The heart of the Discussion Draft is a mechanical concept of "qualified fixed payments," which will inevitably receive mixed reactions. If a mechanical test prevents the transaction I want to do, then it is rigid and artificial. If it

² H.R. Rep. No. 100-795, 100th Cong., 2d Sess. 422-23 (1988).

³ Proposed new section 2701(c).

⁴ Aucutt, *Borras v. Vulcano: The Estate Freeze Meets a Flame-Throwing Statute*, 47 N.Y.U. Inst. Fed. Tax. § 23.15(2) (1989); Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 Tax Lawyer 343, 349 (1989).

permits what I want to do, then it is objective and predictable. Congress ought always to be circumspect about legislating a fiction -- "treating" something as if it were something else. The Discussion Draft does a fair amount of that and therefore should be enacted only with great caution. But, in my judgment, predictability is more important than unlimited flexibility, and a mechanical test is therefore a helpful step toward a workable statute.

Complexity of the Discussion Draft

The Discussion Draft has been criticized for being complex. It is complex. I wish it were less so. Nevertheless, I think it is helpful to consider and weigh two types of complexity which as a practical matter are very different -- statutory complexity and transactional complexity. It may be impossible to eliminate both. If so, I believe that most taxpayers would prefer a complex statute, if it meant that their transactions could be kept simple, understandable, and predictable. Section 2036(c) began as a simple concept⁵ and has become complex only as Congress has tried to make it work. Because I believe that the approach taken by the Discussion Draft will, in the main, permit taxpayers to do what they legitimately want to do, with a minimum of restructuring of transactions, I can accept some statutory complexity.

Nevertheless, the complexity of any statute should be a cause for concern. The Committee should ask whether at some points the complexity of the Discussion Draft is a symptom of an underlying disorder that should be fixed. In a technical appendix at the end of this statement, I refer to a number of improvements to the Discussion Draft that have been suggested, and I suggest a few more. Some of these improvements might even seem to increase the complexity of the Discussion Draft to permit it to serve its purposes, but many others would remove unnecessary complexity and are commended for that reason.

Recommendations to the Committee

I endorse the repeal of the now almost universally discredited section 2036(c). Even if Congress had nothing to replace it, the appropriate action would still be to repeal section 2036(c) outright and promptly.

I also endorse the principle of addressing valuation abuses directly, and therefore, if a substitute for section 2036(c) is desired, I recommend that the Committee continue to pursue an appropriate articulation of a front-end valuation approach. I commend the authors of the Discussion Draft for advancing this important pursuit.

In its consideration of the Discussion Draft, I urge the Committee to continue to view it as both a Draft and a Discussion Draft. Thus, the Committee should encourage its staff to continue to work with their counterparts on the staffs of the Senate Finance Committee and the Joint Committee on Taxation, as well as the Treasury staff, in improving the technical operation of the Discussion Draft.

Similarly, it is very important to continue to maintain a constructive dialogue with the professionals and professional groups that are offering their assistance. I am most familiar with the work of the joint task force of the Section of Taxation and Section of Real Property, Probate and Trust Law of the American Bar Association and the American College of Trust and Estate Counsel and the long-term work on a replacement for section 2036(c) by the Taxation Section of

⁵ Staff of the Joint Comm. on Taxation with the Staff of the Com. on Ways & Means, Description of Possible Options to Increase Revenues 266 (Joint Committee Print, June 25, 1987).

the District of Columbia Bar. I believe that addressing the technical questions raised by the joint task force, and reflecting seriously on the contrasts between the Discussion Draft and the proposal of the Taxation Section of the District of Columbia Bar, are critical to the quality of the final legislative product.

There has been such a dialogue with professionals and professional groups, and I do not mean to suggest otherwise. I mean only to affirm that dialogue and encourage its continuation.

Not to be overlooked is the invaluable assistance of the people in the Internal Revenue Service who will be charged with the task of drafting regulations, interpreting the statute, applying the statute to tough cases, and generally making the statute work. No one has more experience with the exasperation caused by section 2036(c), and no one is more eager to avoid such exasperation in the future. They should be involved early and earnestly.

Conclusion

One feature of the current debate should be kept in view. Despite the many differences in detail among the proposals being urged on the Committee, there are striking similarities in the fundamental approach of several of them. Both the ABA/ACTEC task force proposal, which was presented before and which may have provided some of the basis for development of the Discussion Draft, and the proposal of the Taxation Section of the District of Columbia Bar, which has been under study for several months before its presentation today, are front-end valuation approaches. So is the Discussion Draft. Despite all the differences in detail, some of them extremely important, a front-end valuation approach seems to me to clearly be the consensus choice as the Committee searches for a substitute for section 2036(c). I urge the Congress to continue to develop such a substitute and to act expeditiously, but carefully, to resolve the suspense created by section 2036(c).

TECHNICAL APPENDIX

The technical suggestions and questions of professional groups and others are very important. This is the time to get the statute right. I identify the following trouble spots in the Discussion Draft not as a comprehensive analysis of the Discussion Draft, but only as a supplement:

Scope. The use of the concept of a "10-percent owned entity"⁶ to define the scope of the statute is an understandable transition from the 10-percent "substantial interest" test of section 2036(c).⁷ Nevertheless, the time has come to reconsider this broad reach of the statute to entities so unsubstantially owned by a single family, even including siblings.⁸ If the need for such a statute rests on the presumption that there is no arm's-length conduct within a family, then it should follow that arm's-length conduct is presumed with persons outside the family. The potential for valuation abuse to shift wealth is far less likely when a substantial amount of that shifted wealth will be shared by outsiders. Similarly, the potential for non-arm's-length subsequent conduct is far less in an entity controlled by outsiders. Even under section 2036(c), the Service has given consideration to a safe harbor where more than 50 percent of the voting power and equity interests in an entity are owned by unrelated persons.⁹ The Committee should consider adding the same exception to the Discussion Draft.

Surprising Gifts. The Discussion Draft would produce some surprising results. In addition to the examples other witnesses will cite, I suggest the example of a limited partnership with one five-percent general partner and 19 five-percent limited partners. If one of the limited partners is a child of the general partner, it appears that the ten-percent threshold will be reached by that family. Even if every other limited partner is unrelated to the general partner and to each other, and even if every partner clearly pays full value, the parent might be deemed to have made a gift of some amount to the child,¹⁰ the child might be deemed to have made a gift to the parent, or both, depending on the economic terms of the respective partnership interests.¹¹ Even under section 2036(c), the risk of a transfer from a child to a parent is often overlooked, because it will normally have no significance if the parent dies first. But under a front-end gift tax valuation approach, much greater care is required to prevent such surprising gifts. At a minimum, consideration should be given to a flat rule that section 2701 will never be applied so as to give rise to a gift to a member of an older generation. Although people occasionally do make gifts to their parents, these are usually gifts for consumption, because there could be an estate tax on any property that is not consumed when it returns to a younger generation. "Freeze" gifts to a parent using an interest in a family entity would be very rare.

Elective Qualified Fixed Payments. The Discussion Draft allows a transferor to elect to treat noncumulative dividends or partnership payments contingent on partnership income or cash flow as qualified fixed payments (QFPs).¹² This is very narrow. Ironically, it seems to limit the election to the types of

⁶ Proposed new section 2703(e)(1).

⁷ Section 2036(c)(3)(A).

⁸ Proposed new section 2703(e)(1)(B).

⁹ Notice 89-99, 1989-38 I.R.B. 4, 8 n.19.

¹⁰ The amount of the gift is not entirely clear, but is probably one-nineteenth (5% + 9%) of the investment. Under proposed section 2703(c) (the Discussion Draft's version of the "in effect" rule), a contribution to capital can be treated as a transfer subject to the statute.

¹¹ See proposed new section 2701(a)(2)(C)(iii).

¹² Proposed new section 2701(b)(4).

interests which in the past have been perceived as the most abusive. In light of the gift tax regime to which qualified fixed payments are subjected, there seems to be no reason not to permit such an election for almost any interest.

Indebtedness and Leases. The Discussion Draft provides that payments from a 10-percent owned entity under any indebtedness or lease will be required to qualify as QFPs. It is hard to tell why. If this is only an attempt to make sure the Discussion Draft catches everything that section 2036(c) catches, I submit that section 2036(c) is a discredited standard. Payments under an indebtedness would ordinarily be QFPs and, in any event, would be adequately policed under other Code provisions, such as sections 1272 and 7872. Leases, on the other hand, frequently have escalators based on gross receipts or other factors. Indeed, a lease providing for QFPs, without such escalators, might over time be a classic device to transfer wealth from the landlord to a related tenant. Indebtedness and leases should be exempted from the statute. Alternatively, at a minimum:

- Rent payments should be QFPs if they are based on gross receipts, which, unlike net income, is not likely to be manipulated merely to avoid tax.
- The legislative history should make it clear that rent payments should be QFPs even to the extent they are subject to adjustment by reference to an external index, such as a consumer price index.
- The legislative history should make it clear that rent and interest payments may be taken into account in determining an entity's earnings or cash flow for valuation purposes, even if the value of the lease or indebtedness may not be subtracted from the overall value of the entity.
- Again, liberal election of QFP treatment should be allowed.

Buy-Sell Agreements. No matter how hard one tries, buy-sell agreements in the Discussion Draft will remain a square peg in a round hole. This may again be a result of trying to cover everything section 2036(c) has been viewed as covering — the wrong standard to follow. The extraordinary treatment of buy-sell agreements in the Discussion Draft¹³ departs dramatically from the Discussion Draft's basic front-end valuation approach. Current law, aside from section 2036(c), gives effect to a buy-sell agreement for estate tax valuation purposes if it "represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth."¹⁴ It is hard to tell what is wrong with a standard like that. It may be that this rule could be amended to provide more objective standards, but the case is not compelling. On the other hand, few subjects are as fraught as this one with the potential for confusion and frustration regarding arrangements already in place. It is not at all self-evident how an existing buy-sell agreement or similar contract will be treated, what will be the consequences of amending or failing to amend such an agreement, and what will be the effect of making a brand new agreement. At a minimum, therefore, the legislative history should address such questions in detail. But this might only demonstrate that more study of this subject is needed before a special rule for buy-sell agreements is engrafted on this statute.

Trusts. While there is no reason in principle not to address trusts in this legislation, the many examples of strange results in the case of trusts that will be presented to the Committee by other witnesses suggest that the problem with

¹³ Proposed new section 2702.

¹⁴ Treas. Reg. § 20.2031-2(h).

the treatment of trusts is more than just a question of readability of the statute or ease of location. The application of the rules in the Discussion Draft to trusts needs careful study.

**STATEMENT OF HARRY L. GUTMAN, ESQ., PARTNER, DRINKER
BIDDLE & REATH, PHILADELPHIA, PA**

Mr. GUTMAN. Thank you, Mr. Chairman.

My name is Harry Gutman. I am a practicing attorney in Philadelphia. I am appearing here today as an invited witness to offer comments on the infirmities in the transfer tax structure that led Congress to enact section 2036(c), to comment upon the proposed replacement for section 2036(c) set forth in the discussion draft, and to offer a number of specific suggestions to further the purposes of the legislation.

I do not intend to dwell on the technical issues relating to the discussion draft. Technical issues exist, and others appearing before the committee today have brought many of them to the committee's attention.

Rather, I would like to emphasize a number of more general issues. First, the problem that led to the enactment of section 2036(c) is basically a valuation problem. Therefore, it is appropriate that the proposed replacement focus primarily on valuation issues.

The discussion draft does this and it, therefore, provides a very useful starting point for further elaboration.

Second, it is important to recognize that the Internal Revenue Service must be given the tools, both appropriate statutory authority and administrative resources to deal with these difficult issues. And in this context, the proposals of the District of Columbia Bar deserve particular attention.

Third, whatever legislation is ultimately passed, it should recognize that when closely related parties who are otherwise subject to the statute deal with each other in an arm's-length manner, the special rules of the statute ought not apply. This means that the special rules of the statute should be presumptive, in my view, and taxpayers should be given the ability to refute it by demonstrating to the satisfaction of the Commissioner that their transaction is equivalent to one between unrelated parties.

This presumption should cure some of the concerns of small business representatives who feel that the statute unfairly discriminates against transactions that are engaged in by small business or closely held businesses.

I recognize that this suggestion builds some uncertainty into the statute. However, the alternative is to try to anticipate the terms of the transactions that would be deemed similar to arm's-length transactions so that the statute could be avoided. An extraordinarily complex statute would result. It would be impossible at the outset to determine all of the forms of qualifying transactions. Therefore, regulatory authority and administrative discretion with all of the concomitant lack of certainty, would be necessary in any event.

It is important to recognize that the valuation abuses and planning objectives that are easily recognized in the classic partnership or corporate freeze can be achieved through manipulations of capital structures, sales of stock for notes, buy-sell arrangements and options.

There seems to be little disagreement that the classic and easily recognized situation should be corrected by appropriate legislation.

There is less agreement that other methods of achieving the same substantive result should be subject to similar rules.

I would have thought it obvious that corrective legislation must apply, not only to the classic case, but also any transactional forms that reach the same result. I am uncomfortable with any statutory substitute to section 2036(c) that fails to deal with the abuse potential that can arise if a note, buy-sell agreement or an option is substituted for preferred stock.

I understand that the buy-sell agreement poses a particular problem. No one can plausibly deny that buy-sell agreements serve an important and legitimate business function in general and in closely held businesses in particular.

The desire to control the devolution of ownership of a closely held business, to avoid expensive appraisals to determine purchase price, and to determine and provide for liquidity needs in advance are all concerns.

But, on the other hand, one must recognize that under current law the buy-sell agreement may be used to pass wealth without the payment of transfer tax. One way out would be to provide that agreements or options to acquire property that are entered into between related parties, will be ignored for purposes of determining the value of that property. Any property subject to such an arrangement would be valued at its fair market value without regard to the arrangement. However, the taxpayer would have the opportunity to demonstrate to the satisfaction of the Commissioner that the terms of the agreement were similar to those that were obtained in an arm's-length bargain. Under those circumstances, the value determined under the agreement would be sustained.

The foregoing rule also ought to apply not only to contractual arrangements and options, but also to partnership arrangements and capital structures that have the same effect. Thus situations that have recently faced the courts such as *Harrison v. Commissioner* could be redressed.

I would like to make one additional suggestion. One of the principal reasons for a buy-sell arrangement and one of the items that representatives of the small business community have commented upon is that the buy-sell agreement fixes values so that liquidity needs can be anticipated.

The planning problem under current law for illiquid estates is exacerbated by the uneven statutory relief. There seems to me to be no compelling reason why an illiquid estate no matter what the source of the illiquidity, should not be able to defer the tax attributable to the illiquid assets, so long as the interest rate is sufficient to equate the present value of that deferred tax liability with the tax that would be paid now.

The knowledge that illiquidity relief is readily available ought to alleviate some of the pressure on buy-sell agreements.

In my prepared statement, I also made a number of suggestions with respect to so-called grantor retained interest trust and joint purchases which I think ought to be dealt with in a manner different than that set forth in the discussion draft.

The overriding difficulty it seems to me, Mr. Chairman, in this area is crafting a solution to abusive valuation techniques that distinguishes between those that serve legitimate purposes and those

that do not. This is important in the context of a closely held family business where the mechanisms also contain the seeds for abuse. You have to be scrupulous in devising rules that do not discriminate against closely held family businesses when the activity undertaken is similar to that which would be undertaken by unrelated third parties.

Thank you.

Mr. LEVIN. Thank you very much.

[The statement of Mr. Gutman follows:]

STATEMENT OF
HARRY L. GUTHAN
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
APRIL 24, 1990

Mr. Chairman and Members of the Committee:

I am pleased to appear today as an invited witness to offer comments on the infirmities in transfer tax structure and administration that led Congress to enact section 2036(c), the proposed replacement for section 2036(c) set forth in the Discussion Draft released for comment by the Chairman on March 22, 1990 and a number of specific suggestions to further the purposes of the legislation.

I will not dwell on technical issues relating to the Discussion Draft. Technical issues do exist and others appearing before the Committee today have brought many of them to the Committee's attention. I and others stand prepared to assist in their resolution.

The existence of technical difficulties should not be, and is not being, used as a tactic to divert attention from the underlying issues. Representatives of the organized bar have engaged in an ongoing dialogue with Committee and Treasury staffs with a view toward devising a statutory alternative to current section 2036(c) that both addresses and is limited to legitimate administrative and structural transfer tax problems. It is natural that there will be disagreement as to the scope and nature of the problems. However, disagreement at the margin does not imply that agreement on basic principles cannot be reached. It is in this spirit that I offer below my comments on the scope of the problem and a number of specific solutions to it.

The Scope of the Problem

Over the years, a number of techniques have developed to exploit the transfer tax structure by taking advantage of valuation uncertainties, manipulating valuation tables and creating devices to transfer wealth in ways that are difficult for the Internal Revenue Service (the "Service") to detect. In part these techniques have been successful because lack of adequate notice, manpower and other administrative problems have prevented the Service from detecting and questioning doubtful transactions. Thus, one part of the solution is to provide the Service with adequate notice and manpower to deal with these issues. Another part of the problem has been the court response to cases brought by the government. Here in a significant number of instances, strict adherence to the "willing buyer/willing seller" test has led to results that permit transfer tax avoidance. The solution to this part of the problem is substantive legislation directing a different result in appropriate cases.

The classic illustration of the problem is the "estate freeze" by which corporate or partnership interests are re-arranged with the objective of fixing the value of a retained portion of a business in the transfer tax base of the transferor while transferring the future growth potential to another (in many cases the natural object of the transferor's

bounty) at little or no gift tax cost. There should be no objection to this technique if the retained and transferred interests are properly valued. However, the technique is suspect when the objective is accomplished by creating discretionary features for the retained interests which are alleged to have substantial value but which, in fact, would not be exercised for the benefit of the transferred transferor. Moreover, it is important to understand that the identical objective could be achieved through other manipulations of the business entity's capital structure, sales of stock for notes, buy-sell arrangements, options, or the provision of property or services to the entity through lease or employment arrangements.

There seems to be little dispute that the classic -- and easily recognized -- situation should be corrected by appropriate legislation. There is less agreement that other methods of achieving the same substantive result should be subject to similar rules. I would have thought it obvious that corrective legislation must apply not only to the classic case but also any transactional forms that reach the same result. Accordingly, I am uncomfortable with a statutory substitute to section 2036(c) that fails to deal with the abuse potential that can arise if a note, buy-sell agreement, or option is substituted for preferred stock.

Owners of closely-held family businesses have suggested that section 2036(c) is unfairly targeted at them. The focus of that legislation (and the Discussion Draft) is on closely-held family businesses. This does not necessarily indicate an intention to discriminate against closely-held family businesses. Rather, it is a candid acknowledgment of the fact that more opportunity for manipulation exists in the context of closely held family businesses and therefore greater scrutiny is required. At the same time, it is axiomatic that arm's length transactions between family members should not be subject to special rules. There is no inherent evil in recapitalizing a corporation and transferring a growth interest to a third party. The problem arises when the transferred interests are misvalued. As a notional matter, any time the parties to a suspect transaction can demonstrate that the terms of their transaction are substantially identical to those which would exist in the case of a transaction between unrelated third parties, there is no need for a special statutory rule. Thus, I would urge that any legislation be presumptive and afford taxpayers who are subject to it an opportunity to demonstrate, to the satisfaction of the Commissioner, that the actions they have taken correspond to actions that would be undertaken between unrelated third parties.

I recognize that this suggestion builds some uncertainty and administrative complexity into the statute. However, the alternative is to attempt to anticipate, as a statutory matter, the terms of transactions that would be deemed sufficiently similar to arm's length transactions to avoid the application of the statute. An extraordinarily complex statute would result. Moreover, since it would be impossible at the outset to determine all forms of qualifying transactions, regulatory authority and administrative discretion, with its concomitant lack of certainty, would still be necessary to fill in the interstices.

The Discussion Draft

The Discussion Draft focuses on the valuation abuses that led originally to the enactment of section 2036(c). That seems entirely appropriate at this stage of the process.

Some today have commented on the complexity of the Discussion Draft and their perception that its scope is ambiguous and potentially too broad. I share their concern on both issues but view the resolution as essentially technical. The complexity of the statute reflects the fact that the problem is complex. Simple, broad brush solutions raise the spectre of very unfair individual results unless broad administrative discretion is granted -- and if that is done, the statute will be criticized because its application is uncertain. The tax writing committees can be placed unfairly in a "Catch-22" situation unless all affected constituencies recognize the foregoing realities and look for an appropriate middle ground.

Some have asserted that section 2702, which brings within the ambit of Chapter 14's special valuation rules property subject to purchase at less than fair market value, is unnecessary. I respectfully disagree. The same valuation manipulation that arises through recapitalizations of ownership interests in an entity can occur through contractual arrangements regarding the purchase and sale of interests in the entity.

The classic buy-sell agreement provides a good example. Assume X, age 60, and X's daughter Y, age 30, own all the common stock of a business in the proportion of 80-20. X enters into an agreement with Y, which provides that no shares in the corporation can be sold inter vivos to a third party by either without first offering it to the other at a price equal to the company's book value on the date the agreement is signed. The agreement further provides that upon the death of one of the shareholders, the other will purchase the shares of the deceased shareholder at the same book value price.

The agreement, if upheld for Federal transfer tax purposes, will fix the value of the stock at book value. In substance, therefore, the agreement has the same effect as a preferred stock recapitalization. The value of the retained interest is frozen in the hands of the transferor and the post-execution increase in value passes to the transferee with no transfer tax imposed. Given the age disparities in the example, it is more likely that the father will predecease the daughter. Thus the post-execution growth in the value of the common stock owned by the father will inure to the benefit of the daughter. It is unlikely that unrelated third parties of these ages would enter into such an agreement. Unrelated third parties would be likely to want to capture the full fair market value of their ownership interest for the benefit of their families.

The buy-sell agreement poses a particularly difficult problem. On the one hand, no one can plausibly deny that buy-sell agreements serve important and legitimate business functions in general and in closely-held businesses in particular. The desires to control the devolution of ownership of a closely-held business, to avoid expensive appraisals in determining purchase price and to determine and provide for liquidity needs in advance are all legitimate concerns. On the other hand, one must also recognize that under current law

the buy-sell agreement may be used as a way to pass wealth without the payment of transfer tax.

The Discussion Draft provides that any option or agreement have a striking price equal to fair market value or, where relevant, the purchase price must be determined pursuant to a formula that was reviewed no more than three years before the date of sale and at the time of the review was reasonably expected to produce a price that would approximate fair market value. Critics allege that the fair market value requirement defeats one or more of the legitimate objectives of a buy-sell agreement and that the alternative is unrealistic or uncertain in effect. They suggest that current law provides adequate results.

The objective of the Discussion Draft is laudable and necessary to assure that the statute works evenly. Moreover, I disagree with those who believe that current law provides an adequate solution. The answer to the conflict might be found in a different approach.

One could provide that agreements or options to acquire property that are entered into between related parties will be ignored for purposes of determining the value of that property. Any property subject to such an arrangement would be valued at its fair market value determined without regard to the arrangement. The taxpayer would have the opportunity to demonstrate, to the satisfaction of the Commissioner, that the terms of the agreement were similar to those that would obtain in an arm's length bargain. If that were the case, the value determined under the agreement would be sustained.

The foregoing rule should apply not only to contractual arrangements and options but also to partnership arrangements and corporate capital structures that have the same effect. Thus, the partnership technique sustained in Estate of Harrison v. Commissioner, 52 TCM 1306 (1987), would no longer be effective to reduce value artificially. Similarly the value reductions attributable to specialized capital structures, such as those encountered by the Tax Court recently in Estate of Hall v. Commissioner, 92 TC 312 (1989), and Estate of Newhouse v. Commissioner, 94 TC 19 (1990), might not be sustained. There is no question that those cases should be addressed in legislation designed to remedy valuation abuses.

A Liquidity Relief Proposal

As I noted above, one of the principal purposes for a buy-sell agreement is to fix value so that liquidity needs can be anticipated. The planning problem under current law is exacerbated by the uneven relief presently granted to illiquid estates. There seems to be no compelling reason why an illiquid estate (no matter what the source of the illiquidity, e.g. investment real estate, antiques, or closely held business interests) should not be able to elect to defer the estate tax attributable to the illiquid assets, so long as the interest rate charged on the deferred tax is sufficient to equate the present value of the deferred tax liability with the amount of tax that would otherwise be due immediately. The knowledge that illiquidity relief is readily available might alleviate some of the pressure on buy-sell agreements.

Manipulation of Valuation Tables

The Discussion Draft provides rules to deal with grantor retained interest trusts ("GRITs") and joint purchases. The tax benefits associated with these transactions flow from opportunities to manipulate valuation tables. The abuse potential is serious and should be addressed.

In my view, the appropriate way to address GRITs is to adopt the Treasury I proposals which essentially provide that a transfer is not complete for transfer tax purposes until the transferor has relinquished any economic benefit in the transferred property. If this were done, a transfer to a GRIT would not become complete until the expiration of the grantor's retained interest. The valuation tables cannot be manipulated because they will not apply.

Joint purchases, in my view, are more appropriately dealt with as an income tax problem. If the income tax rules with respect to joint purchases were revised to provide that the remainderman receives taxable income annually in an amount equal to the increase in value of his remainder interest, the income tax advantages of a joint purchase would be ameliorated and the transaction would not occur as a tax avoidance device.

Conclusion

The problem section 2036(c) was enacted to address is real and demands legislative attention. If section 2036(c) is to be repealed, the Discussion Draft approach is a good starting point. If, however, attention is devoted solely to valuation issues, all methods of exploiting valuation rules should be covered. Thus, the legislative solution must encompass business capital structures as well as contractual arrangements that potentially exploit current valuation rules. Moreover, the Internal Revenue Service must be placed in a position where it can enforce these rules. Accordingly, an extension of the gift tax statute of limitations, such as that suggested in the Discussion Draft is appropriate.

The overriding difficulty in crafting a solution to abusive valuation techniques is to distinguish between those arrangements that serve legitimate business purposes and those that do not. This is especially important in the context of closely-held family businesses where the usual mechanisms to deal with legitimate concerns also contain the seeds for abuse. One must be scrupulous in devising rules that do not discriminate against closely-held businesses when the activity undertaken by those entities is similar to that undertaken by unrelated third parties.

I will be pleased to answer any questions.

HLWC:AOB

Mr. LEVIN. Mr. Haviland.

**STATEMENT OF GERARD O. HAVILAND, SENIOR PARTNER,
YOUELL HAVILAND BLISS, FARMINGTON, CT, ACCOMPANIED
BY GARY B. YOUELL, SENIOR PARTNER**

Mr. HAVILAND. Yes, Mr. Chairman, my name is Gerard O. Haviland, senior partner of a consulting firm, Youell Haviland Bliss.

With me is Mr. Gary Youell. Although we appreciate being included in the panel of attorneys, we are not members of the legal profession. We are consultants and we specialize in developing ownership and management succession strategies for family-owned businesses.

Our client companies are not the giants in the field. They are in the \$2 million to \$20 million range in value. Their annual revenues are about the same. And above all else, the principal objective of the company and the family is to keep the business in the family.

These businesses are not just enterprises. They are also a manifestation of family values and family beliefs.

We have no argument with your intent to correct the abuses caused by unfair recapitalization. However, the language of existing 2036(c) is so broad that it has placed in doubt many time-honored techniques for the passing on to the next generation of a medium sized family firm.

As a result, a lot of succession plans that must move forward are currently on hold. Many advisers themselves confused by the complexity of 2036(c) are urging a wait and see attitude because they cannot see other workable alternatives.

I want to address briefly some of the difficulties that 2036(c) has caused for many family businesses with whom we work, and to do that I would like to paint for you a very simple picture.

Let's assume just for the moment that the year is 1946. You are a GI returning from World War II, anxious to get on with your life and you chose to pursue your share of the American dream by starting a business, a manufacturing firm perhaps, and you begin as a small job shop manufacturing precision metal parts.

Over a 40-year career you devote your full energies to building a successful firm. You pour everything you have into the company, your time, your energy, and above all, your capital. In fact, just about every dime of earnings gets plowed back in.

Two of your children, a daughter and a son, have eventually joined the firm and over the past five years they have become the real driving forces behind the business. It is they who are now making it go and grow.

The 40 years have passed and today you are 65. The kids are more than ready to take over the firm and you are ready to pass the baton. You still own all of the stock, the business is your greatest asset and because there is no substantial wealth outside of the business, you need to rely on that business for your retirement security.

You want to do two things. You want to give some ownership to the children now, perhaps using both unified credits and, secondly, you need to figure out a way to change that business value into a

retirement income stream. Estate freezing or recapitalization isn't even on your mind.

Retirement security is on your mind and you need some sort of payment for those years of hard and long work that you put in while building the business. So you call your advisers together. The accountant says your firm is now worth \$10 million, the little firm that you started in 1946. He tells you that eventually it will cost you about \$5 million in taxes or transfer costs just to move the entire business to the next generation. He points out there is no liquidity to pay the taxes.

Your attorney tries to explain 2036(c) and tells you that if you gift any stock to the kids and then you try to retain some income interest for retirement, the future value of that gifted portion will be pulled back into the estate and taxed. That \$5 million tax bill looks even worse now.

After 40 years of hope, you feel beaten. You just can't win. You want to keep the business in the family, but selling on the outside looks like the only solution. How else can you find the retirement income you need and liquidity to pay the taxes?

An outside sale is a good solution perhaps for the government, but a very poor solution for the family, the community and the work force. Unfortunately, however, the outside sale is becoming more and more an attractive option for our family business owners. All across America family businesses are quietly being put up for sale because you have left many owners with no choice.

Something has to be done with 2036(c). Eventually its broad language will kill a large segment of American business.

The proposed draft that you are suggesting is a solid step in the right direction. Regarding estate freezes, we feel that stipulating the manner in which the retained interest will be valued makes good sense and we support that.

Further, we ask that in any revision that very precise language be used so that broad, speculative, and unintended interpretations are not possible. Business owners should be able to move a portion or all of ownership to their children now and further they should be able through deferred compensation agreements or company paid retirement annuities or the business real estate rental income, somehow to be able to use their business asset to produce a reasonable retirement income stream.

Members of the committee, I say to you please keep in mind as you deliberate and decide what to do with this question, most family owned businesses are not gold mines and they are not fountains of freebies for the kids. Rather they are very, a very important and critical part of the American productive system.

Thank you.

[The statement of Mr. Haviland follows:]

Statement of Gerard O. Haviland, Senior Partner
Youell Haviland Bliss

My name is Gerard O. Haviland. I am a Senior Partner of Youell Haviland Bliss, a Connecticut consulting firm that provides consulting and planning services to the owners of family businesses in the Northeast. Our work is primarily concentrated in the areas of ownership and management succession planning. The family owned business is a vital part of the American productive system. Much new technology, most jobs and close to 50% of the goods and services produced in this country have their origins within family owned firms. Family firms in America come in all sizes. Family names such as Marriott, Coors, Johnson and Busch are behind products that are familiar to all of us. At the other end of the spectrum are those businesses, grocery stores, gasoline stations that fall into a category often designated as Mom and Pop businesses. Somewhere in between is the backbone of America and it's those businesses that I wish to speak about today. Manufacturers, movers, advertising agencies, job shops, these are the kinds of businesses that are owned by our clients. Businesses that are typically worth in excess of two million dollars that employ twenty or more people and that are, in every sense of the term, truly family owned businesses.

This type of family owned business is far more than an investment and enterprise. The business represents the values, the hopes and heritage of a family system. Husbands, wives, sons, daughters, brothers and sisters all working together for a common dream. The values that drive these families are the American values of initiative, of entrepreneurship and of self reliance, and it seems to me that the single most important thing that our government can do is to insure that the conditions exist that will help these businesses survive, to grow and to prosper from one generation to the next. Data that is available to us from various sources indicate that close to 70% of the family owned businesses in existence in America today will not survive the difficulties and strains of the generational transfer. There are many reasons for these failures. But more and more often family business owners today are pointing to an extremely complex government regulation as a major reason why the family firm cannot successfully pass from one generation to the next. Now I know that you will hear a lot of good technical analysis today regarding the existing 2036(c) and the revised draft that you have under consideration. My purpose here today is not to talk about the technical aspects of the existing and proposed legislation, but rather to outline to you the tremendous difficulties that family business owners face as the result of 2036(c) as they attempt to figure ways to move their businesses to their children. The kinds of businesses that we represent are not gold mines. Nor are they marginal businesses either. They produced a fair return on the owner's capital and a fair return on their invested time. The typical business is usually the single largest asset in the family's portfolio. Instead of creating wealth outside of the company, by the annual stripping of the company's capital, earnings are continually reinvested and plowed back into the business to make it grow, to make it prosper, to make it more valuable to our country, to the family and to the employees. Sooner or later the owning generation will no longer be able to own and manage the company. Deaths, retirement or possibly even disability will eventually occur. At any of those three points the owning generation faces a significant dilemma. Because they have plowed all their wealth back into the business over the years, they do not have sufficient assets, outside of the business, to sustain them during disability or retirement or to support the survivors at death. Somehow the value that is represented by the ownership of the business must be converted into an income stream to provide financial security. At the same time the owner recognizes that he needs the security, he's also recognizing the fact that ownership somehow must be transferred to the next generation, if the dreams and values and heritage of the family are to be kept alive.

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Clearly the major issues that confront the family business are (1) when the older generation retires, where will they get the income to support their retirement given that over the years they reinvested as much money as possible back into the business and (2) how can the family possibly afford to pay the estate settlement costs that will be due when the older generation attempts to bequest the stock to the next generation at their death (or where the gift taxes will come from if they attempt to gift the stock to the next generation during their lifetime). Section 2036(c), as it is now written, seems to prevent the older generation from retaining an income interest while giving away the growth to the next generation where it properly belongs as they are the ones that will grow the company. What is happening with our family businesses now is that they see no way to control the estate settlement costs and thus are opting to sell their businesses to large corporations rather than passing them on to the next generation.

The bill that is now being proposed is a step in the right direction towards resolving this dilemma. We agree that the abuses that caused the enactment of 2036(c) primarily involve valuation, as it pertains to preferred stock recapitalization. The new bill as we understand it would allow recapitalization, however, there would be a specific valuation formula for the retained interest and a minimum valuation for the growth interests. Clearly the key factor in determining the fairness of this bill will be the "appropriate market discount rate" used in the valuation of the preferred stock. If the rate is set too high, then the business owner will be facing some very difficult decisions. If he goes along and pays the market rate dividend, that dividend may be simply too high for the corporation to afford. If he lowers the dividend, in order to make it more affordable to the corporation, then a significant value will be placed on the common stock thus making the common stock too large to gift out of the estate. We recommend that the market discount rate be set at 50% of six month treasury bill rates.

There are other circumstances and situations that this bill does not seem to address. We have a client that would like to gift all of his company stock to his children, and yet still needs to draw income from the business in the form of deferred compensation or a supplemental retirement annuity. Will there be any restrictions on this type of transaction? Section 2036(c) seems to indicate that all of his stock, gifted away, would be pulled back into his estate at his death because he retained an income interest.

Another client wants to gift the building in which he does business to his children in trust. He desires to have the trust continue to send to him the rental income that the building received from the business, however, his attorney informed him that he would probably run afoul of Section 2036(c). Therefore, the building would be pulled back into his estate upon his death and all of the accompanying estate costs would have to be paid. Obviously the business owner has decided not to make this gift. How would this type of transaction be treated by this new bill?

In summary, we feel again that this bill is a step in the right direction. If the market discount rate is a reasonable one and if the other issues of retaining income after making gifts can be clarified, we feel that this would be a fair bill to our business owners and the other tax paying public of the country.

Sincerely,

Gerard O. Haviland
Gary B. Youell
Chartered Financial Consultant

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Mr. LEVIN. Thank you very much.

Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

I just wanted to comment that I have looked forward to this panel because I consider it one that had opportunity to offer us more hands-on advice, and I particularly appreciate the contribution of my constituent, Gerry Haviland, because not only do they deal constantly with family-owned businesses, but he was a successful owner of a family business.

It is partly through his experience as well as mine and other practitioners in my district that I have become deeply concerned about the impact of this law on small manufacturing, as well as other sectors of our economy in which there are many family-owned businesses.

I just wonder if you would all agree that a rewrite of section 2036(c), that would cost only \$50 million rather than a billion dollars is probably not going to hit enough—it probably will not do for family-owned businesses what family-owned businesses need done for them. I am interested that you all agree that proper valuation is the issue.

On the other hand, if we change the definition of valuation as modestly as the proposed draft does, I hardly think that we are addressing this issue in a way that family-owned businesses need.

Now, I am not a tax lawyer. I am a new member of the committee, so I am using rather generic and general guidance to indicate to me whether I think we have gone far enough.

But just on the basis of the \$1 billion cost versus the \$50 million cost of the alternative indicates to me that there is something deeply flawed about the proposal before us.

And if indeed that is the case, I wish each of you would comment on the most glaring problem with the proposal in the draft before us.

Mr. LUBICK. The discussion draft by levying the tax at the time the gift is made, which is really the proper time to do it, picks up money in the earlier years and then starts losing money in the later years, which is now limited to a 5-year period.

If you extended it out beyond, you would find that there would be a much greater revenue loss from the discussion draft than you would on first blush. In other words, by taxing at the appropriate time, the time the gift is made, rather than as 2036(c) does on a deferred basis, you are going to have a more modest revenue give back at first to taxpayers as a result of the discussion draft, because in the earlier years it is going to pick up revenue. It will lose more in the later years by foregoing inclusion of appreciation in the ultimate estate.

The discussion draft estimate includes the repeal of 2036(c) and even so it is producing a revenue pickup in the earlier years, but I don't think that comparison of saying you are only giving back \$50 million over the five year period really gets to the heart of the problem, which is that you are getting at a correct valuation and a correct application of the estate and gift tax laws, and that is really what I think everybody has indicated is proper.

We should have transfers of property treated the same for businesses as any other kind of property. It is a transfer of wealth that we are taxing and we just want to do it right.

The problem with 2036(c) was that it brought in, subsequent to the gift, an after rising appreciation, and that wasn't appropriate. So I think saying that there is only \$50 million loss from the discussion draft and yet if you repeal 2036(c) you have got \$1 billion. That is not really an appropriate comparison.

Mr. AUCUTT. I think there is also a belief among some of us that if something like the discussion draft or the District of Columbia Bar proposal were enacted, then legitimate transactions, which have been paralyzed because of 2036(c), would again go forward and that those transactions themselves would generate some gift tax, and because of the regime that the discussion draft would put the parties under to conduct themselves properly in an arm's-length manner in the future, we can also expect some additional income tax pick up. Whether that is reflected in these, in the numbers and the estimates, I don't know.

Some heads nodding suggest that they are. But then that, again, would be another answer to why the discussion draft seems to be such a modest change from 2036(c).

In reality, it is quite a dramatic change in its impact on our clients.

Mrs. JOHNSON. Is there any way in which you would like to see it; many of you did address that so we won't go into that now and I will look at your testimony for more specific guidance.

Thank you.

Mr. LEVIN. Let me just say, as we go on to the next panel, it has been immensely patient. Let me just ask you quickly, I think Mr. Haviland's testimony has performed, among other services, the benefit of taking what could easily be one of those second year tax section final exam questions that is the nightmare of all students, somewhat out of that status and kind of boil it down to what everybody would understand, even second year law students.

So let me just ask one or the rest of you quickly, we are trying to separate the wheat from the chaff. Take his example. The working draft in your judgment does what, and is that a just result? Let me just ask you that. Take his example. What happens—

Mr. GUTMAN. Nothing has happened yet in his example because there is some planning that needs to be done. What is the planning that can be done?

Mr. LEVIN. And I thought you would say that.

Now, let me—I don't want to take a long time with that, but it kind of gets at the gist of it. Tell me what you as a lawyer do with that and the consequences under the working draft.

Let's test it for a minute or two. You have that situation, now take two or three alternative courses and what is the result? I mean, some of you advise the client and tell me the practical result under the laws as you understand it would be changed.

Mr. GUTMAN. One of the operating assumptions under the law as it would be changed I think and as it should be is that this is business that we have assumed is appropriately valued at \$10 million.

So we have a business that is a \$10 million business. Now, I would have thought that the appropriate result in terms of a broad

based approach to this is that that \$10 million business ought to pay whatever tax has to be paid on a \$10 million asset in the estate.

I don't hear anything that suggests that this \$10 million asset, if that is what it is worth, ought to be paying tax on a basis other than \$10 million.

Mr. LEVIN. The assumption is that there is going to be a transfer during the lifetime of the war veteran.

Mr. GUTMAN. I understand that.

Mr. LEVIN. And there will be a tax on that.

Mr. GUTMAN. There is going to be a tax on whatever it is that is going to be transferred.

Now, as I understand it, under the working draft you would be able to transfer all post-transfer appreciation. Also, if you tried to transfer all post-transfer appreciation, no matter what kind of transfer was made, the value of the amount of the property that would be deemed transferred to the next generation would be 20 percent of the value of the company. So no matter what was done in this instance, the transaction would involve a \$2 million transfer.

Mr. YOELL. I think the problem with the bill, Mr. Chairman, is that in that instance if we have an \$8 million retained interest, the corporation would then, if the appropriate dividend was going to be 8 percent, then that company would have to pay \$600,000 worth of dividends. There is no way that the company is going to pay that.

So the real key is what is the market discount rate that is going to be used by the Treasury? What market discount rate are they going to use to value that preferred interest? That is what we don't know yet. I don't know what that market value discount thing is going to be.

Mr. LUBICK. First of all, Mr. Chairman, I think our veteran was a little late in starting his planning. He probably should have started 30 years ago, and I assume that we could have gotten out of his estate almost all of the \$10 million.

But assuming that he can live for a substantial period of time, there are a number of transfer mechanisms—

Mr. LEVIN. You mean the \$10,000—

Mr. LUBICK. If he doesn't live long, I think as Hank says, he has a \$10 million asset and he will only pay tax on the \$10 million.

So the question we are concerned with is, as Hank points out, is the question of to what extent you can pay tax limited to what you have now and avoid tax on the future appreciation. It is presumably going to be very difficult, again as Hank says, unless he is willing to value an immediate transfer at \$2 million, which is the 20-percent minimum under the discussion draft to setup an arrangement that is going to freeze it, unless he can live a long time. He could keep it as one class and start making gifts. But to give away that amount of value and get it all out of your estate is going to be very difficult without paying some tax.

Mr. DEES. I think it is important to understand the three scenarios here. Prior to 2036(c), that \$10 million could have been frozen in a sense if he lived for 20 years. He could do a freeze, have included in his estate 20 years from now the \$10 million value of the busi-

ness even though he never paid a dividend to himself over the course of time.

Never converted it back to common. That is the perceived abuse here, that he was able to freeze it without ever paying a thing.

Through inflation the value of the business would grow and through the reinvestment of the earnings 2036(c) reversed the situation. It said even though he was willing to pay \$5 million of gift tax to get that appreciation out of his estate, if he retained an employment contract or some other string to the business, we would still tax the business on the full appreciation even though it may have been entirely due to the child's efforts. That is one of the problems with 2036(c).

What the draft does, assuming you get rid of the 80/20 rule, which is unjustified and discriminates against family businesses, we can go to a situation where the parent can retain income, can have an interest in the business, you don't have to kick pop out, and if he is willing to pay the \$5 million of gift tax up front, or alternatively pay whatever the dividend rate is that is justified under the circumstances so that his estate is not shrinking through the effect of inflation.

It is a fair result from that standpoint.

Now, we have talked about a sale of business for a note. That is one possibility. There, you have to pay the interest so that interest every year accumulates in your estate.

We have talked about the possibility of a freeze existing if you pay the market testing rate. There are lots of ways that we built into the draft an option to either pay the gift tax up front or to pay some continually compounding amount in their estate to offset the effect of the gift.

Mr. LUBICK. The D.C. Bar draft would permit the freezing of \$10 million, would put in assurances that the retained interest is properly valued at the \$10 million, and would permit the transfer of the appreciating junior equity stock.

But, we would have gotten the correct tax on that interest which is retained.

Mr. LEVIN. Maybe we better go on. I have appreciated your comments.

I would urge you, if you have any further ones, to let us know. I think the more I have boiled this down, this complexity to at least questions that are easily understood, we may be able to act effectively.

Thank you.

We are now into the last panel, are we not?

We are not.

Well, then—all right.

The next panel is Mr. Greenhaw, Mr. Merlino, from the AGC; Mr. Greenhaw is from the Retail Hardware Association. From the NAM, Mr. Larson. From the Chamber of Commerce, Mr. Burton, and from the Telephone Association, Mr. Woody.

Mr. Greenhaw is accompanied by Mr. Schnakenberg who is owner of Ace Hardware.

We are going to start with you, Mr. Greenhaw.

One second, while we get our names in place.

STATEMENT OF FRANK W. GREENHAW, OWNER, McWHORTER-GREENHAW HARDWARE, INC., MESQUITE, TX, AND PRESIDENT, NATIONAL RETAIL HARDWARE ASSOCIATION, ACCOMPANIED BY C.J. SCHNAKENBERG, OWNER, SCHNAKENBERG'S ACE HARDWARE, CHICAGO, IL

Mr. GREENHAW. I am Frank Greenhaw, the president of the National Retail Hardware Association, NRHA, a national association of 18,000 hardware store owners. I own a hardware store in Mesquite, Texas.

My son is a third generation hardware man. He is home today operating the business. I am accompanied by C.J. Schnakenberg, also a third generation hardware store owner. He is from Chicago, Illinois.

We are pleased to appear before you to discuss your proposal to replace section 2036(c) of the Internal Revenue Code, a provision that has become a household term in the hardware business.

I compliment the committee for holding these hearings today, and for working to develop this proposal with the cooperation of the Department of Treasury and the business community. The retail hardware industry has been deeply affected by section 2036(c) and stands to be equally affected by your replacement proposal—perhaps more than most small businesses.

Before I get into the details, I would like to state for the record the policy of the NRHA regarding the transfer of family businesses. We believe that small, family-owned businesses play an important role in this nation's economy, and all impediments to the transfer of these businesses should be repealed.

Our problems with section 2036(c) can be summarized as follows:

First, it focuses unfairly on family-owned small businesses.

Second, the current law requires that retailers pay transfer taxes on the entirety of a business assessed value. Because most of this assessed value is tied up in real estate and inventory, we are forced to sell all of the business to pay the taxes.

Third, hardware stores are valued by their market value rather than earning capabilities. This method creates unfair burdensome transfer tax assessments, often encouraging the sale of the business.

The discussion proposal before us today is very important to NRHA members because it signifies to our members that the committee and the U.S. Treasury have chosen to move away from the policeman mentality of 2036(c). However, as written, it fails to help NRHA members transfer hardware stores intact to their children.

The system described in the discussion draft would prevent legitimate transfer of hardware stores to family members for the following reasons.

The proposal attempts to value our business during recapitalizing using the cash-flow method. This system will not help hardware stores. The cash-flow method is most injurious to stores which generate the least earnings. The proposal places enforcement concerns over concerns for the continuing survival of family businesses.

According to this proposal, family business owners are still forced to operate at a competitive disadvantage to those individuals

with wealth represented by other business investments. More specifically, the income stream approach compares the stores earnings with some yet to be determined market rate.

Businesses that can pay qualified fixed payments at or above the applicable federal rates escape large transfer taxes. However, the National Retail Hardware Association estimates hardware stores provide an average rate of return before taxes of less than 4 percent.

— If the market rate chosen to implement the plan is the applicable federal rate of 10 percent, hardware store owners in particular would be in trouble. According to our figures, this would mean that 64 percent of the average hardware store's fair market value could be deemed to be a gift at the time of recapitalizing, and thus subject to the transfer tax. This approach wrongfully assumes that the firm can pay out at a constant rate applicable to yields of other investments or businesses.

When you do the math, you realize most retailers are faced with two alternatives. Sell the business to satisfy the estate obligations or cannibalize the business to meet the presumptive and artificially high rate of return.

Neither of these options encourage survival of a business that pays federal, state and local taxes and the salaries of many employees.

The main problem with section 2036(c) remains the main problem of this replacement proposal. It places family owned businesses at a disadvantage compared to families who have liquid assets represented by cash or collectables.

To sum it up, Mr. Chairman, I am here before you today representing small businessmen who have spent their lives working 50 and 60 hours a week to nurse businesses that sometimes generate a 3 percent rate of return. Without federal funding, we have generated tax revenues and jobs for our communities.

What we want is to transfer these businesses intact to the next generation. Neither section 2036(c) nor the new discussion draft allows this transfer to occur. Therefore, we must respectfully continue to ask for complete repeal of section 2036(c).

[The statement of Mr. Greenhaw follows:]

TESTIMONY OF FRANK W. GREENHAW
OF McWHORTER-GREENHAW HARDWARE, INC.
REPRESENTING
THE NATIONAL RETAIL HARDWARE ASSOCIATION

Mr. Chairman and Members of the Committee on Ways and Means:

My name is Frank Greenhaw, and I am the president of the National Retail Hardware Association (NRHA), a national association of 18,000 hardware store owners. I am accompanied here today by C. J. Schnakenberg, a fellow hardware store owner from Chicago, Illinois. We are pleased to appear before you to discuss your proposal to replace Section 2036(c) of the Internal Revenue Code -- a provision that has become a household term in the hardware business.

I compliment the committee for holding these hearings today, and for working to develop this proposal with the cooperation of the Department of Treasury and the business community. The retail hardware industry has been deeply affected by Section 2036(c) and stands to be equally affected by your replacement proposal -- perhaps more than most small businesses.

Before I get into the details, Mr. Chairman, I would like to state for the record the policy of the NRHA regarding the transfer of family-owned businesses. We believe that small, family-owned businesses play an important role in this nation's economy. Regulations such as Section 2036(c) that impede inter-familial transfer of hardware stores are bad tax policy and should be repealed.

There are three factors that have caused our industry to be adversely affected by section 2036(c):

- First, most hardware stores are small businesses, closely-held and family-owned. These businesses have been singled out under Section 2036(c) because they are presumably more susceptible to "non arms length transactions".

- Second, the assets of hardware stores are largely illiquid, and the application of heavy estate taxes, therefore, often causes the break-up of these businesses. A hardware store's assets consist mainly of inventory, real estate, customer lists and good will. Indeed, the most valuable asset of a hardware store -- its good will -- can only be developed over many years of service in one neighborhood or to one community, and is enhanced as hardware stores are passed along from one generation to another.

- Third, hardware stores, while they may have market value, often have low to moderate earning ratios, and very little cash on hand.

The proposal before us today moves towards the elimination of these problems. Its emphasis on a valuation approach and away from a punitive approach is a step in the right direction, because it reduces some of the inequitable effects of Section 2036(c). However, it still does not constitute an adequate mechanism for the transfer of hardware stores from one generation to another.

We believe that the proposal falls short in two significant respects:

- First, the proposal's reliance on a cash flow method for business valuation during recapitalizations is inflexible, and is an attempt to be scientific in an unscientific area. Basing the amount of the gift on the amount the firm can pay out, as judged

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by a market rate of return, will ensure that hardware stores are disproportionately effected, and

- Second, it continues to emphasize enforcement concerns over sound business planning, placing small family-owned business at a competitive disadvantage to other enterprises.

We believe the estate freeze mechanism is a valid way to transfer a business; and that a properly valued estate does not abuse the use of an estate freeze. We appreciate the concerns of this committee and the Department of Treasury in ensuring that "abuses" in the tax code are addressed, but these abuses cannot be rectified through the application of complex rules which fail to consider business realities.

I. Problems with Current Law for the Hardware Industry

In a nutshell, Section 2036(c) effectively prevents hardware store owners from accomplishing what for many of them is their highest ambition: transferring the business to their offspring. While there are many other lines of business that provide a higher rate of return with less risk and shorter hours, Do-It-Yourself retailers derive a special pleasure from building a living business legacy for their children. By exposing such transfers to estate or gift taxes beyond the scope of any cash reserves that the business might have, 2036(c) effectively encourages the retailer to sell to strangers.

For those who attempt to maintain family ownership, the alternatives can be bleak. The cash needed to pay the transfer taxes can only be generated by selling off inventory or cutting sales staff. Thus, 2036(c) acts to kill the goose that lays the golden eggs, crippling or killing a valuable source of ongoing tax revenues and jobs in order to pay a one-time tax.

Another significant difficulty caused by 2036(c) involves the retailer's inability to plan, with certainty, the complete transfer. By essentially imposing an estate tax system on a gift tax issue, the freeze ban hangs an estate penalty "sword of Damocles" over the head of retailers for the remainder of their lives.

II. The Current Proposal

The discussion draft is meant to permit transfers of future appreciation in classic estate freeze "transactions," regardless of the nature of the asset transferred (i.e. trade or business property, collectible or marketable securities). The proposal, however, ensures that the entire value of the interests transferred are run through the transfer tax system, by means of an elaborate system which is designed to anticipate and preclude any form of abuse.

More specifically, the proposal would permit transfers of future appreciation in a recapitalization, but would safeguard against abuses by: valuing the income stream from the transferred property (discounting the value of the income stream); and ensuring that either: (a) payments are actually made that equal or exceed the income stream, or (b) a gift is deemed to occur. Under the proposal, the income stream constituting payments from the transferee to the transferor after the recapitalization would not be considered to have value unless those payments are qualified fixed payments (QFPs) within the meaning of the proposal. In order for the payments to be QFPs, they would have to be fixed in

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time and amount. The value of the income stream of these QFPs is then to be judged by comparing the income stream to some market rate, which is yet to be determined.

For example, if a condition of the transfer of future appreciation by the transferor was that the transferor would receive a 5 percent cumulative dividend, and the yet-to-be-established market rate was 10 percent (close to the Applicable Federal rate currently) of the value of the retained interest of the transferor would be one-half of the fair market value of the business. This would mean that the firm would incur an immediate gift tax equal to 50 percent of the fair market value of the firm. If the cumulative dividend is not paid out in keeping with the original agreement of the transfer, a gift will be deemed to occur. This deemed gift will be susceptible to gift tax after three years if it is not paid, or if the firm elects, it can be pulled back into the estate if a compound interest rate is applied.

To reiterate, the proposal would treat all retained rights, with the exception of cumulative preferred dividends, as having a zero value. This means that they will be assumed to be worthless, and will not enhance the value of the retained interest. The purpose of this is to ensure that the value of these rights is included in the estate or treated as a deemed gift, i.e., that they do not escape tax consequence.

One of the presumed advantages of the proposal is that it will permit the business to fix the rate of return on the preferred stock at the market rate or at any other rate. Allowing the firm to fix the rate of return is not considered to be abusive because the assignment of a low rate of return on the retained interest will reduce the value of the retained interest and increase the value of the transferred interest, with greater gift tax consequences. Alternatively, the assignment of a high rate of return on preferred stock will cause the value of the preferred stock to be greater than the gift, with greater estate tax consequences. They are only concerned that the agreement to pay a fixed amount actually holds true.

Should the retained interest be transferred by the transferor outside the family (to a third party), the value paid for that interest will be considered the fair market value. There may be immediate gift tax consequences if the payment for the interest is less than the value assigned at the time of the original transactions.

There will be no trade or business requirement. In other words, the proposal will not target family owned businesses over the transfer of other forms of wealth in the family context. Similar rules as provided for recapitalizations will be provided for trusts. However, payments from a trust will be considered QFPs if they are based upon the profit to the trust.

Buy-sell agreements are also covered by the proposal. The proposal will not allow values to be fixed by buy-sell agreements unless those agreements are calculated within three years of the exercise of the option at death.

III. The Current Proposal is Little Better than Current Law as Applied to the Hardware Industry

The Hardware industry will be adversely affected by the current proposal for many of the same reasons it is affected under

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current Section 2036(c). In sum, the new proposal still fails to provide an adequate mechanism for the transfer of family businesses in our industry.

The most significant problem with the proposal is its failure to understand problems of liquidity which exist in the hardware industry. The imposition of a tax on the transfer of a hardware store will, under the proposal, as under current law, require the sale and liquidation of assets integral to the business.

The income stream approach advanced in the proposal would not provide relief for the hardware industry. The approach, as noted, contemplates a comparison of the income stream, or earnings of a business with a yet-to-be-determined market rate. Under the approach, a business will benefit if it is able to pay out a qualified fixed payment which equals or exceeds the market rate return. NRHA's Management Report, the cost of business survey for hardware stores, shows that the annual rate of return (or net operating profit) before taxes is 3.76 percent. If the market rate chosen is the applicable Federal rate of 10 percent, or any rate approximating that rate, a business will incur an immediately assessable gift tax determined on the ratio of 3.76 percent to 10 percent. The difference of 6.24 percent will mean that 62 percent of the fair market value of the business will be deemed to be a gift at the time of the recapitalization. In other words, 62 percent of the business value will be subject to an immediate gift tax, unless the firm can afford a qualified fixed payment rate greater than the prevailing rate of 3.76 percent.

This approach, therefore, wrongfully assumes that the firm can pay out at a constant rate applicable to yields of other investments or businesses. However, a hardware business has a much lower asset to earnings ratio. The result is that a firm is faced with two alternatives:

- (1) Sell the business to satisfy the estate tax obligations; or
- (2) Cannibalize the business to meet the presumptive and artificially high rate of return.

Moreover, the hardware industry, because it is tied to the highly volatile housing market, is more susceptible to fluctuations in the economy. The retail market is too fluid, too flexible and too uncertain to commit to the kind of long-term, inflexible agreement contemplated by this proposal. Conditions can change quickly and make it impossible for the business to pay the QFP; it is also quite possible that conditions will not bring the business back in three years and thus, when it does come back, could face heavy gift taxes. Poor economic performance will then provide a trap which, in conjunction with estate taxes, will make it doubly difficult for a firm to be passed along to second generations. The ability of a hardware owner to pass the business along to his or her offspring should not depend upon these artificial constraints.

Perhaps most importantly, we believe that the main problem with Section 2036(c) remains the main problem with this replacement proposal -- it targets family owned businesses, placing them at a disadvantage compared to families who have liquid assets represented by marketable securities, cash or collectibles. An individual with less than 10 percent ownership in a publicly traded corporation, a wealthy individual with substantial assets in artwork or collectibles, even an individual whose wealth is

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represented by real estate in the form of a principle residence can take advantage of recapitalizations as under the old rules. Only those who have worked hard to acquire a business, performing an important function in their communities, generating tax revenues and jobs, will be adversely affected. Enactment of this proposal would perpetuate this basic inequity. At the root of the problem is not the family-owned business, it is the emphasis of our tax policy.

IV. Conclusion:

Again, Mr. Chairman, we would like to thank you for your leadership on this issue. We feel that this discussion draft has admirably fulfilled its purpose in that it has brought all of us in the small business community to examine the issue and determine exactly what our problems are with current law. Because this draft does not create a satisfactory mechanism for the transfer of hardware stores, we must respectfully continue to support complete repeal of Section 2036(c). Thank you.

STATEMENT OF FRANK MERLINO, PARTNER, DARMODY, MERLINO & CO., BOSTON, MA, AND MEMBER, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. MERLINO. I am here on behalf of the Associated General Contractors, a construction trade association representing more than 32,500 firms, including 8000 general contracting companies who perform more than 80 percent of America's contract construction.

I am the managing partner of a medium-sized certified public accounting firm in Boston, servicing the New England area.

All our clients are closely held firms with the majority of them in the construction related industry.

Ninety percent of these firms are family-owned businesses, many of which have been in existence anywhere from 25 to 75 years and have been passed from one generation to another. Since section 2036(c) has been enforced, these family-owned entities have been faced with a major decision as to whether they want to continue operating as a family entity or sell their company. It would be unfortunate to have the tax implications of section 2036(c) the major factor in making this decision.

AGC appreciates the opportunity to offer its views on section 2036(c) and the problems of value and transfer of family business. In particular, AGC thanks the Chairman and the committee for preparing the draft proposal and requesting comments.

The construction industry is dominated by small family-owned businesses competing in local geographic markets. The broad statutory language contained in section 2036(c) makes estate planning and an orderly business succession very difficult.

The IRS's ability to expand the scope of the statute through regulations creates great uncertainty. Taxpayers may carry out a business succession plan that they believe is not subject to 2036(c) when it is designed. The IRS may decide otherwise years later. AGC, therefore, supports the proposal to repeal section 2036(c) retroactively. It would remove a great deal of uncertainty as to which transfers are covered.

AGC also supports the abandonment of taxing future increases in value by including it in the transfer of real estate. Valuing interest more accurately at the time of transfer is a better approach. In considering any replacement for 2036(c), one goal should be preserving the family business.

The next generation ought not to be penalized for working to build up the family business. They are contributing to the business' growth and increased equity by increasing the common stocks value. They should not be taxed more harshly than strangers.

The proposal would subject transfers to additional levels of taxation. The dividends that must be made are taxed. It limits the ability of the company to grow. If a parent can't transfer the business, it is taxed within the parent's estate.

The child is taxed on the value of the business he or she is helping to build. The draft proposal substitutes a gift tax approach for the estate tax approach. If the company is unable to pay the preferred stock dividend, the company pays a gift tax on the unpaid dividends. If the preferred dividends are not set at a current

market rate, that decreases the value of the preferred stock and increases the value of the common stock. That would ultimately lead to higher gift taxes.

The draft proposal contains several excellent provisions for flexibility. However, there is some concern that the proposal could worsen the effect of business cycles. If the company is cash poor or is encountering problems with operating capital, paying obligatory gift taxes would worsen the financial problems.

The proposal would reduce the ability of business to accumulate capital for expansion. It would force certain payments, regardless of whether the timing would help or hurt the business.

It poses a particular problem for the construction industry. Insurance and bonding capabilities are directly impacted by the business capital structure. Construction contractors must leave equity in the business to ensure adequate bonding capacity so that they may bid on jobs.

The equity that must be left in the business will cause the gift taxes to be higher than they would otherwise be. The draft proposal sets certain valuation rules. The total value of the common stock could not be less than 20 percent of the sum of the total equity of the corporation and any debt owed to the transferor or his family.

Options unlikely to be exercised would not affect the business valuation. This is a sensible solution to the problems Congress identified.

It should eliminate the valuation problem. It is not clear, however, that the transfer should then be subject to higher gift tax rates. AGC appreciates this opportunity to testify and looks forward to working with the committee on this issue.

[The statement of Mr. Merlino follows:]

STATEMENT OF FRANK MERLINO, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America is a construction trade association representing more than 32,500 firms, including 8,000 of America's leading general contracting companies, which are responsible for the employment of more than 3,500,000 employees. These member construction contractors perform more than 80% of America's contract construction of commercial buildings, highways, bridges, heavy-industrial and municipal-utilities facilities.

The construction industry is composed predominantly of small, family-owned firms competing in local geographic markets. Eighty-five percent of AGC's membership has average annual gross receipts of less than \$10 million; ninety percent qualifies under the Small Business Administration's definition of a small business.

AGC appreciates this opportunity to present its views on the estate valuation rules of Section 2036(c). AGC would like to express its appreciation to the Chairman and to the Committee for circulating the discussion draft on reforming the valuation rules and requesting comments.

HISTORY

Section 2036(c) was added to the Internal Revenue Code in 1987. If an individual holds a substantial interest in an enterprise and after December 17, 1987 in effect transfers property having a disproportionately large share of potential appreciation in the enterprise while retaining an interest in the income of or rights in the enterprise, the retention of that interest is considered a retention of the enjoyment of the transferred property. The value of the transferred property comes back into the parent's estate, at its value as of the time of the parent's death.

Section 2036(c) eliminated the traditional corporate and partnership estate freezing techniques. Section 2036(c) went beyond those transactions to cover a variety of other everyday business transactions. The 1988 Tax and Miscellaneous Revenue Act (TAMRA) added several safe harbors, but also added a "deemed gift" rule. IRS Notice 89-99, published on September 1, 1989, gave the first guidance on how the IRS intends to enforce the statute.

PROBLEMS WITH SECTION 2036(c)

The broad statutory language contained in Section 2036(c) makes estate planning and orderly business succession very difficult. Congress also granted the IRS unusually broad authority to write regulations in this area and to expand the types of distributions to which it applies. This broad ability to interpret the statute means that taxpayers may carry out a transaction that is not subject to Section 2036(c) when it is designed, but the IRS may decide several years later that the transaction is actually subject to Section 2036(c). It took two years to get the first guidance on the statute.

For example, Section 2036(c) as presently interpreted by the IRS applies not only to transfers of interest in a business but transfers of passive investments as well. If a parent transfers a bond to a child but retains the right to the interest payments, that transaction is subject to Section 2036(c). That was an extremely broad and unexpected interpretation.

Transfer. Section 2036(c) applies if an individual "in effect transfers" property. That phrase is extremely vague. IRS Notice 89-99 states that it includes the creation of trusts, intra-family sales (including installment sales, private annuities and sales of remainder interests), transfer and leaseback arrangements and joint purchases of income and remainder interests. Transfers may include gifts, sales or trades of property.

"Potential Appreciation." Neither the legislative language nor the notice defines "potential appreciation" or explains how to estimate it. IRS Notice 89-99 established an extremely broad test. The taxpayer is required to assume that any combination of circumstances that would maximize the potential appreciation of the interest would take place.

"Enterprise." Section 2036(c) applies to the transfer and retention of interests in an "enterprise." The legislative language does not define enterprise, but the conference report states that it includes a business "or other property which may produce income or gain." The definition is extremely broad and creates a great deal of uncertainty as to what transactions are covered.

The recent IRS notice states that Section 2036(c) covers passive investment activity as well as the operation of a business entity. Until the guidance was issued, life insurance policies and sales of personal residences were believed to be covered by Section 2036(c). The clarification on those two issues is helpful, but it also indicates the confusion surrounding the scope of Section 2036(c).

Sale to Family Member. Generally, Section 2036(c) does not apply to a transaction if the individual receiving the asset pays fair market value for it. However, Section 2036(c) states that its rules apply to sales to family members, even if the family member pays fair market value for it. If the parent retains an interest in the business or asset, the asset that was sold will be included in the parent's estate.

The only exception is if the family member purchaser can prove that he or she had enough money from other than family sources to purchase the assets. Income from gifts the parent has given the child would not be considered an "outside" source of money.

AGC supports the repeal of Section 2036(c). The repeal removes a great deal of uncertainty as to which transfers are covered and will help family businesses plan an orderly succession.

DISCUSSION DRAFT

AGC supports the abandonment of taxing future increases in value by including it in the transferor's estate. Valuing interests more accurately at the time of the transfer is a better approach. AGC also appreciates the flexibility of the approach contained in the Chairman's draft proposal. AGC would like to offer several points for consideration.

In considering any replacement for Section 2036(c), one goal should be preserving the family business. If the next generation is working to build the business, they ought not be penalized for doing so. Family members should not be taxed more harshly than strangers. Family members working in the business are contributing to its growth and increased equity and to the increase in value of the common stock. They should not face a gift tax as well as income taxes on those efforts.

The draft proposal substitutes a gift tax approach for the estate tax approach. If the company is unable to pay the preferred stock dividends, the company pays a gift tax on the unpaid dividends. If the preferred dividends are not set at a "current market rate," that decreases the value of the preferred stock and increases the value of the common stock. That would lead to higher gift taxes.

The proposal would subject the transfers to additional levels of taxation. The dividends that must be paid is taxed. It limits the ability of the company to grow. If the parent can't transfer the business, it's taxed within the parent's estate. The child is taxed on the value of the business he or she is helping to build.

In the construction industry, insurance and bonding capabilities are directly impacted by the business's capital structure. Construction contractors must maintain equity in the business to ensure adequate bonding capacity to be able to bid on jobs. The equity that must be left in the business to ensure its viability will cause the gift taxes to be higher than they would otherwise be.

The draft proposal could worsen the effect of business cycles. If the company is cash-poor or encounters problems with operating capital, paying gift taxes would worsen the financial problems. If the financial problems are large enough to force forgone dividends, then paying a gift tax will worsen the problem.

The draft proposal would also reduce the ability of the business to accumulate capital for expansion. It would force certain payments regardless of whether the timing would help or hurt the business. There is some flexibility in the proposal which is helpful, but further consideration ought to be given to this issue.

The "current market rate" set in the proposal takes insufficient account of business problems. A national current market rate wouldn't reflect regional economic downturns and the problems faced by businesses. This provision should be eliminated.

The regulatory authority granted to the IRS in this area should be restricted. If the statute of limitations is to be unlimited for transfers subject to the rules that are not reported, then taxpayers should be told what transfers are subject to the rules. Given the current backlog of regulations at the IRS, it would be unfair to subject taxpayers to any uncertainty. The statute should be very specific as to the transactions covered or the statute of limitations should be put back into place.

The statute of limitations should not be unlimited. There can be bonafide disputes as to the application of the statute. Good faith actions should not be penalized years later.

Section 2036(c) was added to the Internal Revenue Code in response to concerns that family businesses were being incorrectly valued. Options that were unlikely to be exercised were thought overvalued. To correct that problem, the draft proposal sets certain valuation rules, as follows:

The total value of the common stock could not be less than 20% of the sum of the total equity in the corporation and any debt owed to the transferor's family. Only certain rights in the corporation would be given value. Other discretionary rights not likely to be exercised in an arm's-length manner would not be permitted to reduce the value of the business.

AGC believes this is a sensible approach to the problem Congress identified and resolves it in a simple manner.

CONCLUSIONS AND RECOMMENDATIONS

AGC believes incentives for entrepreneurship and capital growth are vital for a healthy, growing and competitive economy. To foster competitive and innovative businesses, which in turn provide economic growth and jobs, tax policy must provide incentives for hard work and entrepreneurship. Section 2036(c) penalizes family businesses by making it more difficult for them to financially survive the transfer of ownership. It penalizes efforts to encourage younger generations to join the business, and discourages efforts to sell the business to company employees.

For small businesses to thrive, the founders need to leave capital in the business. In the construction industry, insurance and bonding capacity are directly impacted by the business's capital structure. Construction contractors must leave equity in the business to ensure adequate bonding capacity so that they and their successors may bid on jobs.

Not only does Section 2036(c) affect orderly succession planning, it affects the basic viability of the business. If equity is taken out of the construction company, its bonding capacity is reduced. If equity is left in the company, the founder may die and leave so much valuable equity in the business, the next generation cannot raise enough money to buy the business or pay the estate taxes on it. The business would have to be sold to pay the estate taxes.

This is particularly inequitable when the next generation has been working to build the business. At least part of the buildup of the business has been due to their efforts. As the construction company grows, the increased equity left in the business will make it that much harder for the next generation to take it over. However, under Section 2036(c), the next generation is so hampered by constraints that it often makes economic sense for them to work elsewhere than to stay with the business.

Individuals need incentives to take risks. One of the incentives in forming a family business is the opportunity to pass something on to the next generation. Without incentives, the financial risks that must be faced early in the business's formation are not worthwhile.

The interaction of the estate valuation rules with the other recent tax code changes are hurting small businesses. For example, the 1986 Tax Reform Act repealed the General Utilities doctrine. Previously, a single tax was paid at the shareholder level on liquidating sales and distribution of a business. The proceeds were not taxed at the corporate level. Under current law, if the owner retires and liquidates the business, the double taxation reduces the amount the owner will realize on the sale of the business.

The proceeds from the sale of the company are further reduced by the repeal of preferential tax treatment for long term capital assets. The 1986 Act's repeal of preferential treatment for capital gains means that an owner that had invested for the long term instead of spending for the short term is penalized.

The 1988 tax act further reduced the ability of the owner to sell the company to employees or third parties. Sales of property are restricted in their use of the installment sales method of reporting income.

In effect, the tax code penalizes the owner of a business at the end of his or her career no matter how the transfer is accomplished or to whom the business is sold.

When these provisions are taken together with the estate freeze rules, the consequences to small family businesses are very severe. Owners of construction companies who have taken financial risks and who have devoted a lifetime to building equity in a business and who transfer it to the next generation, transfer it to employees or even sell it to strangers cannot dispose of that business at the close of their careers without being subjected to confiscatory tax rates. This is a great disincentive to entrepreneurship and penalizes investment. AGC believes the most innovative and productive sector of the economy deserves better. AGC recommends that Section 2036(c) be repealed. Any replacement ought to focus on the question of valuation of the business. The next generation, which has been working to build the business, ought not to be treated more harshly than strangers.

Mr. LEVIN. Thank you very much.

Mr. Larson.

STATEMENT OF RICHARD LARSON, CHAIRMAN OF THE BOARD, CHARLES E. LARSON & SONS, INC., CHICAGO, IL, REPRESENTING THE NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY MONICA M. MaGUIRE, DIRECTOR OF TAXATION

Mr. LARSON. Thank you very much, Mr. Chairman, for giving me this opportunity to testify today.

I submit my written testimony for the record.

My oral comments will be brief.

My name is Richard Larson. I am chairman of the board of Charles E. Larson & Sons, Inc., a forging business started in 1895. This is a third and fourth generation family-owned and operated business.

We are located in Chicago, Illinois. We have 100 employees and annual sales of \$15 million. I am here today representing the National Association of Manufacturers. With me is Monica McGuire, the director of taxation for NAM. We applaud the chairman's formation of this discussion draft.

It is a solid first step in correcting the problems imposed by section 2036(c). We hope, in our comments today, to assist the committee in its effort to ensure the continued survival of the American family business.

This issue is critically important—not only to NAM's 9000 small manufacturers like myself, but to larger companies which rely on small family-owned distributorships for the sale of their products. Uncertainty in that distribution chain is economically unhealthy for both large and small companies, as well as the ultimate consumer of the product.

Definitions of the estate freeze and the impact of section 2036(c) have been well covered today. I plan, therefore, to highlight some refinements that will serve to improve the discussion draft, using my own company as a case study of the potential adverse effects that could result.

The discussion draft currently repeals section 2036(c) and recommends a replacement proposal that would more accurately value the various interests at the time of transfer. This replacement proposal is commendable. However, the narrow definition of qualified fixed payments (QFP), excludes items of value.

It is underinclusive because it excludes payments that do not have a value, such as royalties or percentages of gross sales, but are not fixed. We suggest that it may be better to itemize specifically those items or retained rights that will not be considered to have value.

The discussion draft also would negatively result in the next generation being required to pay dividends to the parent generation even when there are strong economic reasons not to do so. Citing my own company as an example, my company's rate of return is not sufficient to provide the income stream required under the definition of the qualified fixed payment.

Mr. Chairman, I opened my remarks by noting that our members considered repeal of section 2036(c) to be critically important to

their future. To Charles E. Larson & Sons, Inc., the current law will be the demise of the 95-year-old business.

Six years ago my company recapitalized, giving common stock to the fourth generation and freezing the value of the preferred stock held by the third generation. Absent repeal or modification, the fourth generation of my company will not be able to afford to transfer business interests to the fifth generation because there is not a sufficient amount of accumulated wealth to pay the current punitive estate tax. The borrowing costs to pay future estate tax liabilities would be excessively high.

My business' available cash for payment of QFPs and estate tax will be further reduced because of the expected decline in the 35 percent of my business which is defense-related work.

Under the proposed requirements of the discussion draft, using a market rate of return of 10 percent or more to value the retained interests of the older generation would overstate the value of the interest transferred to the younger generation.

In the case of my own company, that current value would be relatively small because of my company's recent large capital investment in equipment that has provided technological advances which have contributed to my company's remaining competitiveness in an industry where competitors are increasingly liquidating. One result of this heavy capital investment is that the current income stream is relatively small. NAM, therefore, believes more flexibility in valuation must be allowed.

If the estate freeze rules are not amended, current law could cause a large number of these firms to liquidate.

Such an occurrence would be disastrous not only to the families involved, but for the individuals they employ, the customers they serve, and the Treasury Department—which would lose a steady stream of revenue in exchange for a one-time estate tax collection.

Mr. Chairman, family-owned firms symbolize the values of American enterprise. Not get-rich-quick schemes. Not junk bonds. Not Wall Street game plans to assemble a company and sell out quick to the highest bidder.

Although we recognize serious fiscal restraints face our nation today, NAM believes that an even more desirable step would be eventual elimination of Federal estate taxes on transfers of interest in, or assets of, a closely held business from one family member to the next. Such a move would help ensure the continued prosperity of small family-run business operations that are responsible for critical Federal revenues as well as employment, economic growth and expansion.

[The statement of Mr. Larson follows:]

TESTIMONY
ON
DISCUSSION DRAFT
RELATING TO CHANGES IN SECTION 2036(c)
OF THE INTERNAL REVENUE CODE

BY
RICHARD LARSON
CHARLES E. LARSON & SONS, INC.

ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
HOUSE COMMITTEE ON
WAYS AND MEANS

APRIL 24, 1990

Thank you, Mr. Chairman, for giving me this opportunity to testify today. My name is Richard Larson and I am Chairman of the Board of Charles E. Larson & Sons, Incorporated, a forging business started in 1895. This is a third and fourth generation family-owned and operated business. We are located in Chicago, Illinois, with 100 employees and annual sales of \$15 million.

I am here today representing the National Association of Manufacturers. With me is Monica McGuire, the Director of Taxation for NAM.

We applaud the Chairman's formulation of this discussion draft. It is a solid first step in correcting the problems imposed by Section 2036(c). We hope, in our comments today, to assist the Committee in its effort to ensure the continued survival of the American family business.

NAM believes that estate taxes, in and of themselves, have an adverse impact on capital and initiative necessary for industrial activity and expansion of employment opportunities. The association believes that the overall tax burden on estates--at rates of up to 55 percent--should be reduced. Furthermore, the rules should be amended to avoid hardships and inequities to estates consisting primarily of equity ownership in closely-held businesses, to prevent forced sale of these firms.

This issue is critically important--not only to NAM's 9,000 small manufacturers like myself, but to larger companies which rely on small family-owned distributorships for the sale of their products. Uncertainty in that distribution chain is economically unhealthy for both large and small companies, as well as the ultimate consumer of the product.

Definitions of the estate freeze and the impact of Section 2036(c) have been well covered today. I plan, therefore, to highlight some refinements that will serve to improve the discussion draft, using my own company as a case study of the potential adverse effects that could result.

THE DISCUSSION DRAFT

The discussion draft correctly repeals section 2036(c) and recommends a replacement proposal that would more accurately value the various interests at the time of transfer. This replacement proposal is commendable because it attempts to devise methods to fairly value what is being transferred to the younger generation. However, the narrow definition of Qualified Fixed Payments (QFP) excludes items of value. It is underinclusive because it excludes payments that do have a value, such as royalties or percentages of gross sales, but are not fixed. We suggest that it may be better to itemize specifically those items or retained rights that will not be considered to have value.

The discussion draft also would negatively result in the next generation being required to pay dividends to the parent generation even when there are strong economic reasons not to do so. Citing my own company as an example, my company's rate of return is not sufficient to provide the income stream required under the definition of the Qualified Fixed Payment.

PROBLEMS INDIGENOUS TO FAMILY FIRMS

The discussion draft should be modified to consider problems peculiar to family-owned and operated firms. For example, the draft overlooks the difficulty of obtaining unanimous consent of other family members who own stock in the business--something required in order for a payment to be counted as a QFP. Yet, all too often familial problems having nothing to do with business operations can interfere in such decision-making. I believe this particular issue can be addressed adequately without complicating the proposal.

Mr. Chairman, I opened my remarks by noting that our members considered repeal of section 2036(c) to be critically important to their futures. To Charles E. Larson and Sons, Incorporated, the current law will be the demise of this 95-year-old business.

Six years ago my company recapitalized, giving common stock to the fourth generation and freezing the value of the preferred stock held by the third generation. Absent repeal or modification, the fourth generation of my company will not be able to afford to transfer business interests to the fifth generation because there is not a sufficient amount of accumulated wealth to pay the current punitive estate taxes. The borrowing costs to pay future estate tax liabilities would be excessively high.

My business' available cash for payment of QFPs and estate taxes will be further reduced because of the expected decline in the 35% of my business which is defense-related work.

Under the proposed requirements of the discussion draft, using a market rate of return of 10% or more to value the retained interests of the older generation would overstate the value of the interest transferred to the younger generation. In the case of my own company, that current value would be relatively small because of my company's recent large capital investment in equipment that has provided technological advances which have contributed to my company's remaining competitive in an industry where competitors are increasingly liquidating. One result of this heavy capital investment is that the current income stream is relatively small. NAM, therefore, believes more flexibility in valuation must be allowed.

In a survey of NAM's small manufacturers completed earlier this year, more than 85 percent indicated that they are family-owned and operated. Almost 80 percent of respondents indicated that their business had been in existence for more than 25 years. More than 28 percent of the company CEOs are 60 years of age or older.

It follows that a number of these well-established firms will eventually be changing hands, with controlling individuals ready to pass the reins of ownership and management to a new generation. If the estate freeze rules are not amended, current law could cause a large number of these firms to liquidate.

Such an occurrence would be disastrous not only for the families involved, but for the individuals they employ, the customers they serve, and the Treasury Department--which would lose a steady stream of revenue in exchange for a one-time estate tax collection.

Mr. Chairman, family-owned firms symbolize the values of American enterprise. Not get-rich-quick-schemes. Not junk bonds. Not Wall Street game plans to assemble a company and sell out quick to the highest bidder.

I need to make clear the difference between a public corporation and a private one. A public company has to enhance short-term

earnings and make happy analysts on Wall Street and stockholders throughout the country. A family firm, on the other hand, does not measure its success quarter by quarter. It takes a longer view stretching years or decades into the future. It is willing to take a financial hit--sometimes for years--in the hopes of a strong return at some point later on.

The values of American enterprise add something back to the society in which we live. They provide good jobs. Create products that make life easier. Build companies that pass on through generations and give stability to the communities in which they're located. Contribute to local charities and help when help is needed.

The effect of section 2036(c) has been to strike fear into these family-owned firms. Fear that they will be forced to liquidate. Fear that they will be forced to sell out to absentee owners for whom the company will be just another factory, there to be shut down when the first sign of bad times comes.

Mr. Chairman, we applaud your recognition of this problem, and the steps you have taken in this discussion draft to reverse the significantly adverse effects of Section 2036(c). We have offered a number of suggestions in this testimony, as have others.

Although we recognize serious fiscal restraints face our nation today, NAM believes that an even more desirable step would be eventual elimination of federal estate taxes on transfers of interest in, or assets of, a closely-held business from one family member to the next. Such a move would help ensure the continued prosperity of small family-run business operations that are responsible for critical federal revenues as well as employment, economic growth and expansion.

**STATEMENT OF DAVID R. BURTON, MANAGER, TAX POLICY
CENTER, U.S. CHAMBER OF COMMERCE**

Mr. BURTON. I am David Burton, manager of the Tax Policy Center for the U.S. Chamber of Commerce. I appreciate this opportunity to present the chamber's views on the discussion draft of a proposal to replace section 2036(c) of the Internal Revenue Code released by the Committee on Ways and Means on March 22, 1990.

The chamber has actively supported the repeal of section 2036(c). This provision eliminates estate freeze recapitalizations, calls into question the viability of many other legitimate methods of transferring family business assets from one generation to the next and creates uncertainty with respect to many business arrangements that are unrelated to estate and gift tax planning.

For 3 years, a cloud of complexity and confusion has hung over the entire family business community. As a result, there now seems to be a consensus that section 2036(c) should be repealed. The issue has, therefore, become what will replace section 2036(c).

Before I discuss the chamber's views on the substance of the discussion draft, I would like to take a moment to commend the Committee on Ways and Means and the Department of the Treasury for the process that led to the release of the discussion draft. The process is a model of how the legislative process should work. The process included extensive consultations with business and practitioner groups and was followed by a release of actual statutory language well before markup.

This kind of process will enable the public to review deliberately and make well-considered comments about draft legislation and will result in a superior legislative product.

If this kind of approach to the legislative process were to become the model, there is no doubt that the content of the tax law would improve, the need to revisit and change the law would decline and public respect for the tax system would grow.

A bipartisan effort has moved the process to this point. The chamber thanks Representative Archer for his sponsorship of H.R. 60 and for his determined effort to repeal section 2036(c). This legislation now has 218 cosponsors. Several bills have also been introduced in the Senate to repeal section 2036(c). Senator Symms has introduced S. 659, Senator Daschle has introduced S. 849, and Senator Helfin has introduced S. 838.

There are presently 36 Senators sponsoring or co-sponsoring at least one of these bills. Indeed, the Senate Committee on Finance approved the repeal of section 2036(c) as part of its budget reconciliation legislation last year.

The chamber has carefully reviewed the discussion draft released by this committee as a replacement for section 2036(c). We support the core concept underlying the discussion draft of establishing reasonable rules for valuing retained interests in recapitalizations while abandoning the 2036(c) approach of considering retained interests as retention of transferred property.

However, we have identified significant problems with the discussion draft, and unless a number of significant improvements are made in the draft, the chamber cannot support it. The balance of

my testimony will identify these issues and the manner in which the chamber thinks they should be addressed.

In addition, we have attached draft statutory language as an appendix. This language incorporates the changes to the discussion draft that would need to be made in order for the chamber to support it. We view our draft as only a starting point. There are no doubt ways in which it could be improved and we welcome comments about how it could be improved.

But we are convinced that our draft is a framework for a permanent solution to the problems caused by section 2036(c).

Buy-sell agreements should not be covered by the draft. The draft affects all buy-sell agreements, whether or not they are abusive in any way. The draft would disregard rights of first refusal and require buy-sell agreements to be renegotiated every three years.

The draft establishes an arbitrary and unfounded requirement that the junior equity interest be valued at no less than 20 percent than the equity of the business plus any debt owed to family members. Including the debt in the calculation is improper. Furthermore, 20 percent is too high if recapitalizations are to remain a viable option for family business.

The only exception to the compounding election under the draft is bankruptcy or insolvency. Analytically there should be an additional exception where a dividend would not be paid in an arm's-length transaction. It is difficult to draft such a rule.

We recommend that a bright line, administerable exception to the deemed gift rule be drafted where the sum of the entity's annual earnings and profit plus compensation to family members is less than the required earnings payout, provided there was adequate coverage at the outset of the recapitalization.

If this or a similar rule is not adopted, the business owners who have done recapitalizations may find themselves liable for a gift tax at a time they can least afford it.

The draft permits only two rights to hold value in determining the value of a retained interest in recapitalization voting rights and qualified fixed payments. This approach unfairly excludes many rights that are not abusive and are routinely used in the business world. The chamber's draft replacement statute, which is attached to our testimony as an appendix, would value at zero discretionary rights, would value qualified non-discretionary rights in a way similar to the discussion draft and value a number of other rights, for example, buy-sell agreements, under normal valuation principles.

Because of the importance of the discount rate to the valuation process, there is considerable concern in the business community over how that rate will be determined in practice.

There is concern that the rate may later in the political process or in the regulations be set at an artificially high rate. There is fear that the IRS will on audit regularly attempt to characterize small business securities as low grade high risk securities that should be discounted at a high rate.

At some point in the process there must be an assurance that this will not occur. There are a number of other issues addressed in

my written statement that I will not address here. I appreciate the opportunity to express the chamber's views.

Thank you.

[The statement of Mr. Burton follows:]

TESTIMONY
on
DISCUSSION DRAFT OF REPLACEMENT FOR SECTION 2036(c)
before the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
David R. Burton
April 24, 1990

I am David R. Burton, Manager of the Tax Policy Center for the U.S. Chamber of Commerce. I appreciate this opportunity to present the Chamber's views on the "Discussion Draft" of a proposal to replace section 2036(c) of the Internal Revenue Code released by the Committee on Ways and Means on March 22, 1990.

The Chamber has actively supported the repeal of section 2036(c). This provision eliminates estate freeze recapitalizations, calls into question the viability of many other legitimate methods of transferring family business assets from one generation to the next and creates uncertainty with respect to many business arrangements that are unrelated to estate and gift tax planning. It jeopardizes the continuity of family ownership of many farms and businesses. Section 2036(c) was enacted without Congressional hearings or debate, and even now many families who are affected by the law are just discovering its existence. For three years, a cloud of complexity and confusion has hung over the entire family business community. As a result, there now seems to be a consensus that section 2036(c) should be repealed. The issue has therefore become what will replace section 2036(c).

Before I discuss the Chamber's views on the substance of the discussion draft, I would like to take a moment to commend the Committee on Ways and Means and the Department of the Treasury for the process that led to the release of the discussion draft. The process is a model of how the legislative process should work. The process included extensive consultations with business and practitioner groups and was followed by a release of actual statutory language well before mark-up. This kind of process will enable the public to review deliberately and make well-considered comments about draft legislation and will result in a superior legislative product. If this kind of approach to the legislative process were to become the model, there is no doubt that the content of the tax law would improve, the need to revisit and change the law would decline and public respect for the tax system would grow.

A bipartisan effort has moved the process to this point. The Chamber thanks Representative Archer for his sponsorship of H.R. 60 and for his determined effort to repeal section 2036(c). This legislation now has 218 cosponsors. Several bills have also been introduced in the Senate to repeal section 2036(c). Senator Symms has introduced S. 659, Senator Daschle has introduced S. 849 and Senator Heflin has introduced S. 838. There are presently 36 Senators sponsoring or cosponsoring at least one of these bills. Indeed, the Senate Committee on Finance Committee approved the repeal of section 2036(c) as part of its budget reconciliation legislation last year.

The Chamber has carefully reviewed the discussion draft released by this Committee as a replacement for section 2036(c). We support the core concept underlying the discussion draft of establishing reasonable rules to value for gift tax purposes retained interests in recapitalizations while abandoning the 2036(c) approach of considering retained interests as retention of the transferred property. However, we have identified significant problems with the discussion draft, and unless a number of significant improvements are made in the draft, the Chamber cannot support it. The balance of my testimony will identify these issues and the manner in which the Chamber thinks they should be addressed. In addition, we have attached draft statutory language as an appendix. This language incorporates the changes to the discussion draft that would need to be made in order for the Chamber to support it. We view our draft as only a starting point. There are no doubt ways in which it could be improved and we welcome comments about how it could be improved. But we are convinced that our draft is a framework for a permanent solution to the problems caused by section 2036(c).

Buy-Sell Agreements

Nearly every closely held business has a buy-sell agreement. These agreements can take many forms, including cross-purchase, redemption or right of first refusal agreements. Rarely are these agreements motivated by the desire to avoid transfer taxes. Unfortunately, for reasons that are unclear to the Chamber, section 2702 of the draft would fundamentally alter the transfer tax treatment of buy-sell agreements. Section 2702 arbitrarily values taxpayers' property (generally an interest in the entity) without regard to a right of first refusal or a lease burdening the property. Furthermore, for purposes of the estate and gift tax subtitle, the value of property would be determined without regard to any option or agreement to purchase the property at a price less than fair market value (determined without regard to the option or agreement) as of the time the option or rights under the agreement are exercised unless the formula determining the price at which such property is sold is "reviewed" (an ambiguous term which may or may not mean renegotiated) every three years.

This aspect of the discussion draft is universally viewed within the business community as unacceptable. The provision affects all buy-sell agreements of any type, whether or not part of a recapitalization, whether or not estate and gift tax motivated and whether or not they are abusive in any way. The provision would affect literally hundreds of thousands of routine buy-sell agreements that are of greater duration than three years and based on a formula -- no matter how reasonable or commonplace the agreement may be.

The requirement that the agreement be reviewed every three years will be an additional expense and burden that every prudent small business will need to incur, and the provision poses practical difficulties, particularly if nonfamily members are parties to the agreement. The provision is virtually guaranteed to lead to inadvertent noncompliance because every small business in America does not have a comprehensive review of every agreement to which it is a party every three years. Small businesses are in the business of running their business, not reviewing legal minutia. And for businesses that have not done a recapitalization with sophisticated estate planning counsel, this provision no doubt ranks as legal minutia. This provision would introduce an entire new complexity into every buy-sell agreement in the U.S. to address a putative "problem." Yet neither the Department of the Treasury nor Congressional staff has argued that buy-sell agreements are generally abusive or generally entered into for tax avoidance purposes. If there are abuses in this area, and the Chamber is not convinced that there are, then legislation should be narrowly drafted to stop those abuses.

The Chamber believes that the entire proposed section 2702 should be dropped from any replacement statute. The requirement of a three-year review of buy-sell formulas should be dropped. Any replacement statute must also acknowledge that property can be valued with reference to rights of first refusal, leases burdening the property and buy-sell agreements.

The Minimum Valuation Rule for the Junior Equity Interest

The draft establishes an arbitrary and unfounded requirement that the junior equity interest (generally common stock in a corporate context) be valued at no less than 20 percent of the sum of the equity of the business plus any debt owed by the business to the transferor (and his family). There are three problems here.

First, including debt in the calculation of the 20 percent is improper. The calculation should include only the equity of the business, otherwise the "unfrozen" portion of the business could in fact be considerably higher than 20 percent of the equity of the business. In fact, this provision alone could virtually prohibit recapitalizations in fairly typical situations. Assume the following facts: A business has assets worth 100x; debt of 80x (held by family members) and shareholders' equity of 20x; 100 shares of common held by parent p; therefore, the shareholders' equity is 0.2x per share of common. Parent p wants to initiate a recapitalization and transfer his common interest and future appreciation (or depreciation) to children c in exchange for a preferred stock interest with a market value approaching the value of his common stock interest. The draft would

require that the children c's common stock be worth 20 percent of the sum of 80x (the debt owed to the family) and 20x (the equity). Twenty percent of 100x (the sum) equals 20x. Thus, under the draft, under these fairly typical facts, there would be no amount that parent p could freeze because the junior interest would have to be equal in value to the entire equity value of the firm. If parent p retained any preferred interest, then the value of junior interest would fall below 20x but the statute would ignore any decline in value. Follow the example further. Assume that parent p does a recapitalization retaining a preferred stock interest equal to 80 percent of the equity of the firm (16x) in exchange for 80 shares of common worth 16x and gives 20 shares of common to children c worth 4x. Under normal economic principles, a fair result would be that he owed a gift tax on his gift of 4x. But under the discussion draft, he would owe an immediate gift tax on 20x - an amount equal to parent p's entire equity interest and an amount 400 percent higher than the actual gift. Moreover, it is not clear whether the rules under proposed section 2701(e) that parent p would not be liable for an estate tax on the retained preferred stock interest worth 16x.^[1] Under the draft, a firm with a four to one debt to equity ratio would be able to freeze no portion of the value of the enterprise, and a firm with any debt to any family member would conceivably be liable for double taxation on any frozen portion.

Second, 20 percent is simply too high a figure if recapitalizations are to remain a viable option for most family businesses. The immediate gift tax (or income tax if the 20 percent interest is sold to the heirs) consequences of a recapitalization under this proposal will be prohibitive for many business owners. The stated goal of the draft is to prevent abusive recapitalizations, not all recapitalizations. And it should not be forgotten that the gift tax can often be more burdensome than the estate tax since the Code has no gift tax analog to the installment payment provisions of section 6166.

Third, there is no need for a minimum valuation rule. By disallowing the use of discretionary rights for purposes of valuing the retained interest the proposal would provide at least a fair market value for the equity interests in the business and will often overvalue them. There is no reason for an arbitrary floor on the value of the junior interest.

The Deemed Gift Provisions

The only exception to the deemed gift and compounding election regime under the draft is bankruptcy or insolvency. Analytically, there should be an additional exception where a dividend would not have been paid to an unrelated party in an "arms-length" transaction. The nonpayment of a dividend in the "arms-length" situation would not be considered a gift and should not be a deemed gift under the draft. Yet drafting a rule that would capture all of the situations in which a business might not pay dividends in a unrelated party context is quite difficult. Therefore, the Chamber recommends that a highly administrable, bright-line rule designed to capture the situation when a business is not paying dividends because of a business down-turn be adopted. If such a rule is not adopted, then business owners that have done recapitalizations may well find themselves liable for a gift tax at the very time that they can least afford it. We recommend an exception to the deemed gift rule where the sum of the entity's annual earnings and profits plus compensation to family members is less than the required earnings payout. This exception would apply only where there had been adequate coverage in the three years prior to the transaction giving rise to the required payout.

[1] Proposed section 2701(e) attempts to eliminate the double taxation of "specially valued retained interests". That term is defined in section 2703(e)(2) to include only those interests determined under subparagraph (A) and (B) of section 2701(a)(2). Therefore, presumably section 2701(e) would not operate to alleviate double taxation that resulted from overvaluations occurring due to the application of section 2701(a)(3).

Retained Interest Valuation

The primary goal of the draft should be to prohibit the use of certain abusive discretionary rights in valuing the retained interest of the business. Basing value on these rights can be abusive in a family business context because they can be granted to the retained interest with the understanding and intention never to exercise those rights and therefore to increase the retained interest's value and to decrease the junior interest's value. Unfortunately, the approach to the valuation of retained interests in the draft turns this approach on its head. The statute identifies those rights (qualified fixed payments (QFPs) and voting rights) that are to be assigned value and requires that all other senior retained rights be valued at zero. In essence, the draft assumes that everything other than voting rights and QFPs are abusive. This is an unreasonable and incorrect assumption. The correct approach for the draft is to list those retained rights that are abusive and therefore can be assigned no value and permit all others to hold their appropriate fair market value. In addition, it would aid the practical understanding and administrability of the statute if the statute made it clear that a certain commonly created rights could be valued according to ordinary valuation rules.

Qualified Fixed Payments (QFPs)

If the right to QFPs were to remain as the only right that holds value other than voting rights, then the definition of a QFP would at minimum have to be expanded to include a number of nondiscretionary rights often retained by the transferor for business reasons rather than for tax avoidance. The draft defines a QFP as a payment that is fixed as to time and amount. Therefore, any interest that is not absolutely fixed as to time and amount is valued at zero. This produces an unreasonable result. For example, a lease providing that a portion of the lease payment is based on a percentage of the lessee's revenue is both quite common and quite valuable but will be valued at zero. For example, a grocery or retail store that paid a percentage of sales lease when transferred would be valued as though it paid no lease at all. Other retained interests that appear to be non-QFPs include royalties and any equity interest that has any participatory component, including a covenant that the holder of the retained interest be fully repaid for his investment before the junior interest receives a return. This is particularly common in a partnership context when an agreement provides that one partner receives all profits until his initial investment in the partnership is recovered and then receives a relatively determinable return. The draft would therefore have two adverse effects. First, many nondiscretionary retained interests would be valued at zero. Second, the value of junior interests could be inaccurately inflated since it will be assumed that none of these payments are made.

The Discount Rate

The proposal implies that businesses will be permitted to select their own cumulative dividend or payout rate and that this will be matched against an appropriate but undefined discount rate. The rate at which the stated dividend or payout is discounted will in large measure determine the value of the retained interest. There is, of course, a high degree of intellectual merit to the idea that this rate should be set at a market rate based on the circumstances of each individual firm. Yet because of the importance of the discount rate to the valuation process, there is significant anxiety in the business community over how the rate will ultimately be determined in practice. There is fear that the rate will be set later in the political process or in the regulations at an artificially high figure. There is also fear that the Internal Revenue Service on audit will regularly attempt to characterize small business securities as low-grade, high-risk securities that should be discounted at a high rate. There should be some assurance, perhaps in report language, that this will not in fact occur. A specified rate, of course, is attractive in some respects. Most importantly, of course, it would provide for certainty, but a specified rate would also simplify the process of recapitalization.

Leases and Debts

Debts and leases are specifically identified as interests in the entity in section 2703(e)(3). This is unwarranted because there does not appear to be evidence that valuation abuses have occurred with leases, and any problems that might arise with debt can be adequately dealt with by code provisions such as section 7872 and section 6662(g). Furthermore, many people do not consult with attorneys when simple debt or lease agreements are entered into, and their inclusion in the proposal will unnecessarily complicate the negotiation of such agreements and impose costs on taxpayers.

The Compounding Cumulative Preferred Election

A business that does not experience the long-term growth anticipated at the outset of a recapitalization may find that the compounding effect defeats the very purpose of a recapitalization by creating a huge estate in relation to the value of the business. In fact, as the draft is presently written, the value of the preferred interest for estate tax purposes may well exceed the fair market value of the entire business. The draft should provide for a cap on the value of the preferred stock for estate tax purposes and should not exceed the value of the equity of the company.

The 10 Percent Threshold for Application of Chapter 14

A transferor who owns only a 10 percent interest in the "entity" would not be able to initiate an abusive recapitalization. Moreover, the draft uses family attribution rules that would include virtually all family members in determining whether there is 10 percent ownership. The Chamber believes that the appropriate threshold is a 50 percent interest in the entity, including those interests attributed under appropriate attribution rules.

The Definition of Insolvency

Section 2701(f)(2)(A) excludes from the determination of insolvency any liabilities to the transferor or members of the transferor's family. This appears to exclude not only loans but also any unpaid dividends due to family members. Ignoring legitimate debts due to family members in determining insolvency would be highly burdensome. In a small business context, loans to businesses are routinely made by family members because banks and other sources of credit are unwilling to take the risk of financing a small, entrepreneurial venture. Yet these debts remain debts all the same and should certainly be included in calculating the total debt burden of the business.

The Definition of Family

The definition of family under section 2703(a)(1) is quite broad but reasonable. However, the addition of 2703(a)(2) treats any person as a member of the transferor's family if the transfer would otherwise be considered a gift. Therefore, it is clear that relatives outside the immediate family or even nonrelatives will be considered family members.

The Statute of Limitations

The draft makes several unwarranted changes concerning the statute of limitations. First, the gift tax statute of limitations is extended from three years to six years for transfers subject to these provisions. The Chamber sees no reason for a special exception to the statute of limitations to be made here. It is highly important that the determination of tax liability become certain within a reasonable period. Three years is as long a period as tax years should remain open. Second, the statute of limitations is tolled where any gift of property valued according to section 2701 and required to be reported on a gift tax return is not reported on that return. The tolling of the gift tax statute of limitations indefinitely is unfair to taxpayers and could create particular burdens where the transferor

considered the transaction in question to be a sale and therefore did not report it on a gift tax return. In fact, this becomes a particular problem in any area where the statute may be interpreted broadly to include transactions about which various parties are unaware or which they would not assume are included under the statute. In any such situation, the transaction will go unreported and the statute of limitations is endless. It should be noted that the law already includes section 6501(e) which extends the statute of limitations from three to six years where an estate or gift tax return improperly omits an amount exceeding 25 percent (substantial omission of items) of the amount reported on the return.

The Chamber is also concerned that the information reporting requirements will increase substantially with this proposal. Section 2703(f)(3) authorizes regulations to impose information reporting requirements. These would apparently apply to not only the initial transfer but also to all deemed gift transactions under section 2701(c) and section 2701(d). There is, at the very least, the need for greater specificity about what kind of requirements can be imposed on taxpayers.

Trusts and Joint Purchases

Much of the complexity of the draft comes from the fact that it addresses far more than recapitalizations. Those aspects of the proposal that address trusts and joint purchases should be addressed in separate legislation. The rules governing the valuation of trusts are unique, and the attempt to address trusts in this legislation makes the proposal overly complex. It is not clear to the Chamber why joint purchases are included in the draft. If there is a need for legislation in this area, it too should be addressed separately, not as part of legislation intended to deal with corporations and partnerships.

Another reason for the overbreadth and practical complexity of the draft is that it adopts an expansive definition of "abuse." No statute can anticipate and eliminate all conceivable abuse. Statutes that attempt to do so will more often than not simply impose extreme burdens on law-abiding and well-intentioned citizens. The Chamber and others involved in the effort to repeal section 2036(c) are willing to consider legislation that will curb valuation abuses in business recapitalizations. Yet, in the interest of fairness to the vast majority of taxpayers who do not abuse the system, the antiabuse provision should be narrowly drafted, and easily understandable and should not result in high compliance costs for most taxpayers.

The Consent Requirement

Section 2701(b)(3)(B) of the proposal provides that payments under any instrument held by a member of the transferor's family shall not be treated as QFPs unless such member consents to be treated in the same manner as the transferor for purposes of applying the deemed gift rule and other requirements. Therefore, if consent is not obtained, rights held by family members not immediately involved by the transaction covered by chapter 14 will have no value in the calculation of the value of an interest transferred between parent and child. There is concern that in certain situations this provision may even give relatives veto power over the recapitalization arrangement. The provision assumes a harmonious relationship among family members that often does not exist, and once again further complicates the valuation procedure outlined in the draft.

Technical Changes

In addition to the broad issues outlined above, it appears that there will be a need for some clarifications of the statutory language used at various points in the draft. Many of these clarifications will be technical items that arise because of the complexity in this area of the law generally and in the discussion draft in particular. For example, it seems fairly clear that only section 2207B(b) should be repealed not the entire section.

Another example concerns the wording in section 2703(c) of the draft stating that any redemption, recapitalization, contribution to capital or other change in capital structure that has substantially the same effect as a transfer of an interest in such entity shall, except as provided in regulations, be treated as a transfer of an interest in the entity. The preferable reading would be to state that such transactions will constitute a transfer of an interest in the entity to the extent provided in regulations.

A further example concerns the refund provision for the gift tax paid on an omitted dividend that is later paid. Provision is apparently made under section 2701(c)(3) for the gift tax (although it is unclear if the statute works as intended), no provision provides for a refund of the generation-skipping-transfer tax.

Conclusion

The Chamber hopes that these comments will help in the difficult task of devising a workable and uncomplicated replacement for section 2036(c). The process that the Committee on Ways and Means and the Department of the Treasury have inaugurated is commendable. The Chamber looks forward to continuing a constructive dialogue and looks forward to a satisfactory replacement to 2036(c) being enacted into law. Thank you.

Appendix

The proposal set forth in this appendix is based on the discussion draft but incorporates the changes outlined in my testimony. This statutory language no doubt can be improved, and we welcome suggestions about how our proposal could be improved. Yet I believe that it offers a workable alternative to the discussion draft that would both solve most if not all of the major problems that business has experienced with 2036(c) and prevent abusive recapitalizations. It is offered in the hope that it will provide some guidance as to the sort of statute that the business community could support.

Description of proposal: The amended draft repeals section 2036(c) retroactively. Section 2036(c) is replaced with special valuation rules for business recapitalizations. The valuation rules would not apply to buy-sell agreements, trusts or joint purchases. In valuing a retained interest any discretionary liquidation, conversion, put, discretionary dividend right or other right to a payment or distribution the payment of which is at the discretion of the transferor or the corporation or partnership would be valued at zero. Any promise to make a Qualified Non-Discretionary Payment (QNDP) will be valued according to rules substantially the same as the discussion draft's QFP rules. All other rights, a number of which are specifically enumerated, would be valued under normal valuation principles. As with the Ways and Means Committee draft, the nonpayment of a QNDP within three years will trigger a deemed gift (unless the compounding option was provided for in the instrument paying the QNDP). In addition to the bankruptcy and insolvency exceptions, there is an exception where the sum of the entity's annual earnings and profits plus compensation paid to family members is less than the QNDP provided the entity had adequate coverage in the three years prior to creation of the instrument giving rise to the QNDP.

Certain other changes to the discussion draft are also made.

PRELIMINARY DISCUSSION DRAFT
(April 24, 1990)

PART ____ PROVISIONS RELATING TO ESTATE FREEZES

SEC. ____ REPEAL OF SECTION 2036(c).

(a) IN GENERAL.- Section 2036 (relating to transfers with retained life estate) is amended by striking subsection (c) and by redesignating subsection (d) as subsection (c).

(b) CONFORMING AMENDMENTS.- Section 2207B is amended by striking subsection (b) and by redesignating subsections (c) through (e) as subsection (b) through (d).

(c) EFFECTIVE DATE.- The amendments made by this section shall apply in the case of property transferred after December 17, 1987.

SEC. ____ SPECIAL VALUATION RULES.

(a) IN GENERAL.- Subtitle B is amended by adding at the end thereof the following new chapter:

"CHAPTER 14 - SPECIAL VALUATION RULES

"SEC. 2701. SPECIAL VALUATION RULES IN CASE OF TRANSFERS OF INTERESTS IN 50-PERCENT OR MORE OWNED ENTITIES.

"(a) TRANSFERS OF INTERESTS IN CERTAIN ENTITIES.-

"(1) IN GENERAL -

"(A) TRANSFERRED EQUITY JUNIOR INTERESTS. - Solely for purposes of determining whether a transfer of a junior equity interest in a 50 percent or more owned entity to a member of the transferor's family is a gift (and the amount of such gift), the value of any preferred equity interest in such entity retained by the transferor (or his or her spouse) shall be determined under paragraph (2).

"(B) PREFERRED EQUITY INTERESTS. - For purposes of subparagraph (A), the issuance to an individual of any preferred equity interest in a 50 percent or more owned entity in exchange for property constitutes a transfer of an equity interest by that individual to the owners of the junior equity interests in such entity proportionately of an amount equal to the excess, at the time of issuance, of the value of the property exchanged by that individual for such preferred equity interest over the value determined under paragraph (2) of such preferred equity interest received by that individual.

"(C) DISPOSITION OF SPECIALLY VALUED PREFERRED EQUITY INTERESTS. - For purposes of this subtitle, the value of a transfer by the transferor (or his or her spouse) of a preferred equity interest which has been valued under paragraph (A) (a "specially valued preferred equity interest") or the value of any other right under the instrument evidencing such interest, shall be the value determined under paragraph (2), except that this subparagraph (C) shall not apply to transfers to the spouse or surviving spouse of the

transferor which qualify for a deduction under any one of sections 2056, 2106(a)(3) or 2523 or would qualify for such deduction except for the consideration paid by the spouse.

"(2) VALUATION OF CERTAIN PREFERRED EQUITY INTERESTS. -

"(A) IN GENERAL. - The value of the preferred equity interest shall be determined by valuing any discretionary rights under the instrument evidencing such preferred equity interest (meaning any liquidation, conversion, put, call, or other right to a payment or distribution the payment of which is at the discretion of the transferor or the corporation or partnership) at zero.

"(B) VALUATION OF QUALIFIED NON-DISCRETIONARY PAYMENTS. - For purposes of determining the value of the right to receive qualified non-discretionary payments under any instrument, the value shall be determined by discounting such payments employing the assumption that -

"(i) such qualified non-discretionary payments will be made as provided in such instrument, and

"(ii) if such instrument has no non-discretionary termination date, payments under such instrument will be made in perpetuity.

"(C) VALUATION OF CERTAIN OTHER RIGHTS. - This section shall not apply to the valuation of the following which shall be determined without regard to this section:

"(i) Any interest of the same class as the transferred interest.

(ii) Any discount for minority interest or lack of marketability with respect to the transferred junior interest

(iii) Any rights with respect to the retained preferred interest which have no preference over any rights under the transferred interest

(iv) Any option, buy-sell, cross-purchase, redemption or other agreement to buy or sell property interests.^[2]

(v) Employment agreements, debt, leases and other non-equity interests .

(vi) Rights of first refusal agreements and other transfer restrictions

(vii) A payment or right which is (i) a function of any published index, (ii) directly related to sales or production, or (iii)

[2]Additional language in the statute or report language based on Treasury Regulations Section 20.2031-2(h) may be appropriate on further examination. It would read: The effect of any such agreement shall depend on the circumstances of each particular case. Little weight will be accorded a price if the agreement permits the disposition of the underlying securities at any price during lifetime, such as an agreement to purchase the shares a decedent may own at his death. Even if the agreement precludes transfers during life at other than the agreed price, such price will be disregarded unless it is determined under the circumstances of the particular case that the agreement is a bona fide business arrangement and not a device to pass property to the natural objects of the transferor's bounty for less than an adequate and full consideration in money or money's worth. If the agreed price is disregarded under this subparagraph, the restrictions may still be considered transfer restrictions that affect value.

otherwise not subject to the discretion of the transferor, his or her spouse or the 50 percent owned entity

"(D) DISCOUNT RATE. - The value of the qualified non-discretionary payments under any instrument shall be determined by appropriately discounting future payments.

"(E) BUSINESS VALUE. - The value of any preferred equity interests determined under this paragraph (2) shall be reduced by an amount equal to value reduction ratio times the excess value amount. For purposes of the preceding sentence, the term value reduction ratio means the value determined under paragraph 2 divided by the value of all preferred interests and the term excess value amount means the amount by which the value of all preferred interests exceeds the value of the 50 percent owned entity.

"(b) DEFINITION OF QUALIFIED NON-DISCRETIONARY PAYMENTS. - For purposes of this section-

"(1) QUALIFIED NON-DISCRETIONARY PAYMENT.-

"(A) IN GENERAL.- The term 'qualified non-discretionary payment' means -

"(i) any payment or distribution (other than a dividend) with respect to any interest in the entity to the extent such payment or distribution is non-discretionary as to both amount and time for payment, and

"(ii) any dividend payable on a periodic basis under any cumulative or non-cumulative preferred stock to the extent such dividend is determined at a non-discretionary rate.

"(B) TREATMENT OF VARIABLE RATE PAYMENTS.- For purposes of subparagraph (A), a payment shall be treated as non-discretionary as to amount or rate if such payment is determined at a rate which bears a fixed relationship to a specified market interest rate.

"(C) CERTAIN PAYMENTS NOT QUALIFIED. - An amount which is payable under any instrument issued by a corporation or partnership and which is subject to a life contingency shall not be treated as a qualified non-discretionary payment.

"(2) ELECTIONS. -

"(A) Waiver. - A transferor may elect to treat any payments under any instrument as payments which are not qualified non-discretionary payments.

"(B) SPOUSAL CONSENT. - Payments under any specially valued preferred interest retained by transferor's spouse (who has not otherwise consented under section 2513 to the transfer of the junior equity interest) shall not be qualified non-discretionary payments unless such spouse consents to the application of paragraph (C) below.

"(C) OTHERWISE DISCRETIONARY PAYMENTS.- A transferor or his or her spouse may elect to treat any right to a payment or distribution with respect to a retained preferred equity interest as a qualified non-discretionary payment by specifying the amounts and

times at which such payments or distributions shall be made, provided such times and amounts are not inconsistent with the instrument giving rise to such rights.

"(D) TIME AND MANNER OF ELECTION. - The elections provided in this subparagraph (2) shall be made on the first gift tax return due for the period in which the transfer of the junior equity interest occurred and once made shall be revocable only with the consent of the Secretary or his designate.

"(c) DEEMED GIFTS WHERE QUALIFIED NON-DISCRETIONARY PAYMENTS ARE NOT MADE. -

"(1) IN GENERAL. - A qualified non-discretionary payment under any retained specially valued preferred interest, to the extent not made before the close of the 3rd calendar year following the calendar year in which such payment was due, shall be treated as a gift made by the transferor (or the transferor's spouse in the case of consent under section 2513 or section (b)(2)) on the last day of such 3rd calendar year.

"(2) EXCEPTIONS. - Paragraph (1) shall not apply to any payment under any retained instrument if -

"(A) the transferor or his or her spouse does not hold such instrument as of the close of the 3rd calendar year referred to in paragraph (1), or

"(B) a family member of the transferor did not hold the transferred junior equity instrument at the time the non-discretionary payment was due, or

"(C) the instrument evidencing such interest provides that any qualified non-discretionary payment not timely paid shall bear interest compounded annually from the date such payment was due at a rate not less than the discount rate used in valuing such qualified non-discretionary payment under subsection (a)(2)(D), or

"(D) INADEQUATE EARNINGS AND PROFITS. -

(i) the retained interest's proportionate share of the sum of the entity's annual earnings and profits plus compensation (as defined in section 162(a)) paid to family members (as defined in section 2702(a)) in any calendar year is less than the qualified non-discretionary payment payable in such calendar year with respect to that instrument, provided that this exception shall not apply unless, in each of the three taxable years prior to the year of creation of the instrument giving rise to the qualified non-discretionary payment, the proportionate share of the sum of the entity's annual earnings and profits plus compensation (as defined in section 162(a)) paid to family members (as defined in section 2702(a)) exceeded 150 percent of the average qualified fixed payment payable in the first three full taxable years after creation of the instrument giving rise to the qualified non-discretionary payment.

(ii) DEFINITION OF EARNINGS AND PROFITS. - For purposes of this subsection, if the entity is a corporation, then the definition of 'earnings and profits' in section 312 shall apply and if the entity is a partnership, then 'earnings and profits' shall be the sum of net income or loss, and net capital gain or loss (but excluding charitable contributions) as defined in section 702.

(iii) PROPORTIONATE SHARE. - For purposes of this subsection, the term proportionate share means the ratio of the

value of the retained interest to the value of all the preferred interests of the entity.

"(E) it becomes due during any period of insolvency or bankruptcy (as defined in subsection (e))

"(3) REFUND OR CREDIT IF PAYMENT SUBSEQUENTLY MADE. -

If any portion of a qualified non-discretionary payment is treated as a gift made by the transferor under this subsection and such portion is subsequently paid to the transferor -

"(A) any tax paid by the transferor under chapter 12 by reason of such gift shall be treated as a payment of tax under chapter 12 made by the transferor for the calendar year in which such portion is paid, and shall be refundable to the transferor upon application to the Secretary in such manner as he shall prescribe, and

"(B) such portion shall be excluded from taxable gifts (and any credit allowable under section 2505 by reason of such gift shall be disregarded) for purposes of determining the amount of the tax imposed by this subtitle on transfers (including by reason of death) made by the transferor during the calendar year in which such portion is paid or any subsequent year.

"(4) ADJUSTMENT TO SUBSEQUENT VALUATIONS OF INSTRUMENT. - The portion of any qualified non-discretionary payment under any instrument which is treated as a gift by the transferor under this subsection shall be disregarded in subsequently determining the value of such instrument for purposes of this subtitle in the case of any transfer of such instrument by such transferor or the death of such transferor.

"(d) ADJUSTMENT IN VALUE OF SPECIALLY VALUED RETAINED RIGHTS. - In the case of any right under a specially valued retained interest other than a right to receive qualified non-discretionary payments, for purposes of -

"(1) determining whether any transfer of such right by the transferor is a gift (and the amount of such gift), or

"(2) determining the amount includible in the gross estate of the transferor by reason of such right,

under regulations prescribed by the Secretary (and subject to such conditions as may be prescribed in such regulations), the amount otherwise treated as the value of such right shall be reduced (but not below zero) by the amount of the increase in any prior taxable gift made by the transferor resulting from such right being valued under subsection (a)(2)(A).

"(e) INSOLVENCY AND BANKRUPTCY. - For purposes of this chapter -

"(1) INSOLVENT. - The term 'insolvent' has the meaning given to such term by section 108(d).

"(2) TITLE 11 CASE. - The term 'title 11 case' means any case under title 11, United States Code.

"(3) EXTINGUISHMENT. - Subsection (c) shall not apply to any qualified non-discretionary payment to the extent the right to receive such payment is extinguished in the title 11 case.

"SEC. 2702. DEFINITIONS AND SPECIAL RULES.

"(a) FAMILY. - For purposes of this chapter, the term 'family' means with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual and any spouse of any of the foregoing. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.

"(b) OTHER DEFINITIONS AND SPECIAL RULES. - For purposes of this chapter -

"(1) 50-PERCENT OR MORE OWNED ENTITY.-

"(A) IN GENERAL. - The term '50-percent or more owned entity' means-

"(i) any entity taxed under subchapter C of subtitle A if 50 percent or more of the value of the stock in such corporation is held (directly or indirectly) by the transferor,

"(ii) any entity taxed under subchapter K of subtitle A if 50 percent or more of the value of the capital or profits interest in such partnership is held (directly or indirectly) by the transferor.

For purposes of the preceding sentence, the transferor shall be treated as holding any interest in an entity held (directly or indirectly) by such individual's spouse, parent or grandparent.

"(2) SPECIALLY VALUED PREFERRED INTEREST. - The term 'specially valued preferred interest' means any retained interest if the value of such interest was determined under subparagraph (A) or (B) of subsection (a)(2) of section 2701 for purposes of applying section 2701(a)(1).

"(3) EXERCISE OF DISCRETIONARY RIGHTS. - Except as provided in subparagraph (c) of section 2701, no exercise or failure to exercise a discretionary right with respect to a preferred equity interest shall be considered a transfer for purposes of this subtitle.

"(c) REGULATIONS.- The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this chapter.

(b) TECHNICAL AMENDMENT.- Section 1015 (relating to basis of property acquired by gift) is amended by adding at the end thereof the following new subsection:

"(f) SPECIAL VALUATION RULES TO APPLY.- The rules of chapter 14 shall apply in determining the fair market value of any property at the time of the gift for purposes of this section."

(c) CLERICAL AMENDMENT.- The table of chapters for subtitle B is amended by adding at the end thereof the following new item:

"Chapter 14. Special valuation rules."

**STATEMENT OF JAMES H. WOODY, EXECUTIVE VICE PRESIDENT,
UNION TELEPHONE CO., MOUNTAIN VIEW, WY ON BEHALF OF
THE UNITED STATES TELEPHONE ASSOCIATION**

Mr. WOODY. I am pleased to testify on behalf of Union Telephone Co. and the United States Telephone Association, USTA. USTA is the primary trade association of the local exchange carrier industry, representing over 1100 members, approximately half of which are family-controlled businesses. As a small businessman, I appreciate the opportunity to present views on estate valuation freezes and Chairman Rostenkowski's estate freeze discussion draft. I am executive vice president of Union Telephone Co., a family-controlled telephone company that serves 2,900 customers in Wyoming, Utah and Colorado.

Like many others, I believe that repeal of section 2036(c) is necessary. While most would agree that some legislation is necessary to prevent valuation abuses in family transfer-of-control transactions, current section 2036(c) makes it extremely difficult, if not impossible, for older generations to continue to be involved in the business, which may be essential to the continued success of the business.

Section 2036(c) is overly broad and unworkable and causes confusion. I therefore believe that if legislation is required to curb valuation abuses, it should be more equitable, narrower in scope and simpler in its application than section 2036(c).

The discussion draft bill appears to me to be a step in this direction, although I understand the experts find the bill to be too broad. I willingly defer to those more versed in the estate and gift tax field to discuss the technical issues with you. I am most concerned with those sections of the bill dealing with situations where the older generation begins to turn over control and active management of a family business to the younger generation. This is basically what my father wishes to do with our family business.

My grandfather founded our company in 1914. For three generations, my family has been meeting the telecommunications needs of our customers. Today, my father, mother, wife, two brothers, sister, son and nephew work for the company. We also employ nearly 30 others from the local community. The family owns 67 percent of the company stock. The rest is held by others in our community. We are not a wealthy company. All of our net operating profit goes back into our plant, equipment and services. In fact, we have never paid a dividend to any of our shareholders.

My father, who is 68 years old, currently controls the company, but would eventually like to transfer control, over time, to my brothers, sister and me.

Under current 2036(c), we understand that such a transfer would be complicated and, perhaps, not economically viable, if my father wanted to continue to be involved with the business which, at this time, is necessary. If we cannot make such a transfer, the family would, at some point, be forced to sell the business. We do not want to sell. Like many small telephone companies, we have made a commitment to our customers and our community. For example, to adequately serve our customers, we have invested \$5,000 in equipment per customer.

I believe that a transfer of our company by my father to the younger generations would be viable under the draft bill which, by and large, takes a fair approach to the valuation issues involved in a transfer. I would, however, like to focus on a few areas where I believe the draft bill must be improved. First, I understand that a transferring shareholder, such as my father, would have to receive a so-called qualified fixed payment with respect to any interest he might retain in preferred stock of the company. Such a fixed payment is based on the assumed value of the retained preferred stock. I understand that, in fixing such value, only certain types of retained rights are given value, while all other rights and payments are ignored and valued at zero. This appears to us to be the wrong approach. If the abuse in family transfers has been the overvaluation of the preferred stock kept by the older generation attributable to what are called bells and whistles features, then no value should be assigned to them. But, on the other hand, all other rights and payments should be valued on a willing seller/willing buyer basis. In other words, the bill should define what does not have value, rather than to give an overly narrow definition of what does have value. This approach would more accurately reflect reality.

I also believe that a safe harbor that would put a specified value on the stock retained by the older generation if certain dividend requirements were met would be useful.

I am also concerned about the deemed gift provision of the draft bill. As I understand it, in the context of a company recapitalization, such a provision would treat the failure by a business to pay dividends to the preferred stockholder as a gift by that stockholder to the holders of the common stock. But it would be inequitable to penalize a small business if it is unable to pay dividends due to downturns in the economy or setbacks suffered by the business itself. Also, if the business was able to pay a dividend and chose not to, it is my understanding that a gift could be deemed to have been made under other provisions of the code. Therefore, the deemed gift rule of the bill seems to serve no legitimate economic function and creates a real element of uncertainty.

Finally, I understand that the task force has recommended that the bill delete all references to buy-sell agreements. I agree. I believe we are willing to pay an appropriate tax on these transfers, but only ask that it be structured in a way that does not threaten our viability as business people.

Thank you very much for your time.

[The statement of Mr. Woody follows:]

STATEMENT OF
JAMES H. WOODY
EXECUTIVE VICE PRESIDENT
UNION TELEPHONE COMPANY
ON BEHALF OF
THE UNITED STATES TELEPHONE ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

APRIL 24, 1990

— Mr. Chairman and Members of the Committee:

I am pleased to testify on behalf of Union Telephone Company and the United States Telephone Association (USTA). USTA is the primary trade association of the local exchange carrier industry, representing over 1100 members, approximately half of which are family-controlled businesses. As a small businessman, I appreciate the opportunity to present views on estate valuation freezes and Chairman Rostenkowski's estate freeze discussion draft. I am executive vice president of Union Telephone Company, a family-controlled telephone company that serves 2,900 customers in Wyoming, Utah and Colorado.

Like many others, I believe that repeal of Section 2036(c) is necessary. While most would agree that some type of legislation is necessary to prevent valuation abuses in family transfer-of-control transactions, current Section 2036 (c) makes it extremely difficult, if not impossible, for older generations to pass family businesses to younger generations in an orderly and economical fashion. It makes it very difficult for the older generation to continue to be involved in the business, which may be essential to the continued success of the business. Section 2036(c) is overly broad and unworkable and causes confusion among not only lawyers and legislators, but businessmen as well. I therefore believe that if legislation is required to curb valuation abuses, it should be more equitable, narrower in scope and simpler in its application than Section 2036(c).

The Draft Discussion Bill appears to me to be a step in this direction, although I understand the experts find the Bill to be too broad. I willingly defer to those more versed in the estate and gift tax field to discuss the technical issues with you. I am most concerned with those sections of the Bill dealing with situations where the older generation begins to turn over control and active management of a family business to the younger generation, and hopes to continue the process over a reasonable period of time. This is basically what my father wishes to do with our family business.

My grandfather founded our company in 1914. For three generations, my family has been meeting the telecommunications needs of our customers. Today, my father, mother, wife, two brothers, sister, son and nephew work for the company. We also employ nearly 30 others from the local community. The family owns sixty-seven percent of the company stock. The rest is held by others in our community. We are not a wealthy company. All of our net operating profit goes back into our plant, equipment and services. In fact, we have never paid a dividend to any of our shareholders.

My father, who is 68 years old currently controls the company, but would eventually like to transfer control, over time, to my brothers, sister and me.

Under current 2036(c), we understand that such a transfer would be complicated and, perhaps, not economically viable, if my father wanted to continue to be involved with the business which, at this time, is necessary. If we cannot make such a transfer, the family would, at some point, be forced to sell the business. We do not want to sell. Like many small telephone companies we have made a commitment to our customers and our community. For example, to adequately serve our customers, we have invested \$5,000 in equipment per customer.

I believe that a transfer of our company by my father to the younger generations would be viable under the Draft Bill which, by and large, takes a fair approach to the valuation issues involved in a transfer. I would, however, like to focus on a few areas where I believe the Draft Bill must be improved. First, I understand that a transferring shareholder, such as my father, would have to receive a so-called "qualified fixed payment" with respect to any interest he might retain in preferred stock of the company. Such a fixed payment is based on the assumed value of the retained preferred stock. I understand that, in fixing such value, only certain types of retained rights are given value, while all other rights and payments are ignored and valued at zero. This appears to us to be the wrong approach. If the abuse in family transfers has been the overvaluation of the preferred stock kept by the older generation attributable to what are called "bells and whistles" features, then no value should be assigned to them. I think this approach should be taken if conversion rights of preferred stock are merely illusory or if the right to require a liquidation of the company will, in all likelihood, never occur. But, on the other hand, all other rights and payments should be valued on a willing seller - willing buyer basis. In other words, the Bill should define what does not have value, rather than to give an overly narrow definition of what does have value. This approach would more accurately reflect economic reality and thereby place a more realistic value on the retained preferred stock. It could make the qualified fixed payments less onerous on the younger

generation and help to keep the business functioning effectively.

I also believe that a safe harbor that would put a specified value on the stock retained by the older generation if certain dividend requirements were met, would be useful. I understand that such a recommendation has been made by the Task Force of the American Bar Association and the American College of Probate Counsel.

I am also concerned about the deemed gift provision of the Draft Bill. As I understand it, in the context of a company recapitalization, such a provision would treat the failure by a business to pay dividends to the preferred stockholder as a gift by that stockholder to the holders of the common stock. Clearly, when the transaction is made, there is every intention to pay the preferred shareholder the required dividends. But, it would be inequitable to penalize a small business if it is unable to pay dividends due to downturns in the economy or setbacks suffered by the business itself. Also, if the business was able to pay a dividend and simply chose not to, it is my understanding that a gift could be deemed to have been made under other provisions of the Code. Therefore, the deemed gift rule of the Bill seems to serve no legitimate economic function and creates a real element of uncertainty that would inhibit family transfers.

Finally, I understand that the Task Force has recommended that the Bill delete all references to buy-sell agreements. I agree. As with the deemed gift problem, abuses in buy-sell agreements can apparently be dealt with through other provisions of the Code. The provisions contained in the Bill would only serve to create an extra burden, both on our time and on our finances. The only real beneficiaries are the lawyers and appraisers who would be needed to review and revalue the agreements every three years. Frankly, it is that kind of diversion from our business duties that turns willing taxpayers into frustrated and sometimes angry constituents. I believe we are willing to pay an appropriate tax on these transfers, but only ask that it be structured in a way that does not threaten our viability as business people.

Thank you very much for your time.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. McGRATH. Mr. Greenhaw, enumerate for us instances where section 2036(c) has affected members of the Hardware Association.

Mr. GREENHAW. Yes, sir. I would like to call on Charles Schnakenberg from Chicago, a third-generation hardware dealer, to respond to that.

Mr. SCHNAKENBERG. Congressman McGrath, I am the embodiment of Mr. Havilland's hypothetical World War II veteran. I am third-generation owner of a small business. Last year, I purchased the business from my father and it was a done deal. I thought we were finished.

Subsequently, my accountant and attorney tried to explain 2036(c) to me. Because of a deferred compensation agreement from my father and the fact that my father owns the property, I don't know what tax ramifications there will be 10, 15, 20 years down the line, and if there are major tax implications.

Because of the competitive pressure our business is currently under, I don't think I would have any choice but to sell the business to pay the tax. That is why I am here.

Mr. McGRATH. Thank you.

Mr. Burton, you have in your testimony enumerated a lot of major problems with the draft. You enumerated the requirement of a minimum 20-percent value for junior equity interest in recapitalization. You have talked about the 3-year grace period and the compounding option where dividends cannot be paid. You have talked about the discussion draft's qualified fixed payment concept.

Could you tell us what might be a simplified method of what we have proposed in the draft other than complete repeal without any substitution?

Mr. BURTON. The Chamber believes the discussion draft represents a framework for solution to the problem, but that there are a number of changes that need to be made before it solves the problem. There are probably four basic things that are changed in a revision of it that we proposed in an appendix to our testimony.

One is that buy-sell agreements basically are taken out of the draft. Buy-sell agreements, including buy-sell agreements that are not part of a recapitalization are not affected. Another is to drop the 80-20 rule which in its present form includes debt. It is 20 percent of the whole business. That can lead to some pretty typical situations where you can't even do a freeze.

The third thing is the qualified fixed payment concept, which is another—which another panel mentioned. It basically says, if it is not a qualified fixed payment, then it is worth zero. That means a whole series of pretty commonly done things are going to be valued at zero, including rights of first refusal, including percentage of sales leases, including all royalties.

Anything that is not fixed in time and amount is going to be valued at zero. That will lead to inappropriate results.

The last thing is that even though the provision does retain one exception to the deemed gift rule, it doesn't contain any other exceptions, including in cases where the taxpayer would not have paid the dividend even in the case of an unrelated party.

What we have done is suggested a rule where if there was sufficient coverage for the 3 years prior to doing the transaction, then if

the combined earnings and profits plus compensation drops below the dividend amount, then there is an exception to the rule, which seems like an administerable rule that would handle the problem in case of a business downturn.

Mr. McGRATH. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Any further questions?

Thank you very much, ladies and gentlemen.

Welcome to the committee. We appreciate your patience. I am sorry we carried you through lunch. We appreciate the fact that you are willing to participate in this discussion and give us the benefit of your views.

Mr. Benz, you are the lead-off.

Mr. FRENZEL. Mr. Chairman, I would like to introduce Mr. Benz to you and the committee. George is now a constituent of Bruce Vento's rather than my own. In the olden days, our families lived for a few summers side by side. We did grow up together. I am pleased the committee will hear from him now, because he was very smart in those days, and I don't think things have changed at all.

Chairman ROSTENKOWSKI. Mr. Benz, I would consider that he was maybe the teacher and you were the student. Mr. Frenzel is probably one of the most articulate members of this committee.

Mr. Benz.

STATEMENT OF GEORGE B. BENZ, VICE PRESIDENT, AMERICAN BANCORP, AND PRESIDENT, GEORGE BENZ & SONS, ST. PAUL, MN

Mr. BENZ. Good afternoon, Mr. Chairman, and members of the committee. My name is George Benz. I am vice president of American Bancorp, a small bank holding company in Minnesota and a trustee of a trust created by my grandparents more than 50 years ago which owns a controlling interest in American Bancorp. Either through direct ownership of American Bancorp or indirectly through the trust, the decedents of my grandparents control approximately 80 percent of the stock of American Bancorp.

With respect to the current estate freeze rules, it is my opinion that these rules should be repealed in their entirety, retroactive to the date of enactment, December 17, 1987. I understand that the intent of section 2036(c) was to prevent avoidance of transfer taxes. I heartily agree with this. However, I believe that better enforcement of existing rules should be sufficient to prevent avoidance of these taxes.

This can occur if these transactions are required to be reported irrespective of whether or not transfer taxes are currently due.

Assuming Congress wants to enact additional rules specifically relating to transfers with retained interests, the method by which Congress implemented the new rules in 1987 is far too broad and unduly complex.

I agree that a better approach is the one outlined in the chairman's discussion draft. I believe that the discussion draft takes the right approach by addressing the allocation of value between family members, rather than taxing future appreciation to the individual no longer owning the property.

The approach should not prevent intrafamily transfers at fair market value. To do so would inhibit growth and expansion of American business.

I am concerned that, as drafted, many existing arrangements will be unduly burdened by being required to become qualified fixed payments. In some cases, specifically my family, the interests owned by some individuals would not, and could not, be modified to become qualified fixed payments. Thus, the discussion draft effectively precludes transfers of any interests, other than a complete termination of the individual's interest.

Let me expand upon this point as I am sure you do not intend to limit transfers between family members which are not designed to avoid transfer or income taxes. I am most concerned with the rules when property is held in an irrevocable trust whose investments are controlled by an independent trustee.

For example, our family members have a life interest in a trust which holds stock in American Bancorp. These family members also own stock directly in American Bancorp which may be periodically gifted or sold to other family members. Because the life interest is not a qualified fixed payment and because it cannot be modified to become a qualified fixed payment, that interest will be valued at zero.

If we assume that the family member gives away all their American Bancorp common stock which is held outright and maintains only their life interest in the irrevocable trusts which owns stock in American Bancorp, the value of the taxable gift will be the value of the stock gifted and the value of their life interest.

How could the committee correct this inequity in the proposed rules? A number of different approaches could be taken to correct this result. The easiest would be an effective date which provided that, for purposes of these rules, an arrangement existing on a specified date would be deemed to be an interest or arrangement which made qualified fixed payments. A means of making the law more flexible would be to provide that a person's "interest" in property is very narrowly defined and does not include interests which own the identical property.

I believe that any legislation using the discussion draft approach will effectively preclude or inappropriately tax some valid business transfers. If this is true, at least existing arrangements should be unaffected.

The current taxation of future appreciation or the proposed taxation of a nonqualified fixed payment, high estate tax rates and the generation-skipping transfer tax effectively prevent the transfer of family-owned businesses from one generation to the next.

To pay taxes in an inflationary society will require the sale or liquidation of family businesses. This is clearly counterproductive from a business standpoint and will cause inefficiencies in the national economy.

Central to the free enterprise system is the opportunity for individuals to build and create wealth for themselves and their families. This incentive is impeded and frustrated by an estate tax system which requires a family business that has been built over several generations to be taken apart to pay transfer taxes. This

system effectively works as a disincentive to build and establish a successful closely held family business.

In conclusion, I am extremely pleased to see that Chairman Rostenkowski and the Ways and Means Committee have taken significant steps towards protecting a sacred American tradition, the closely held family business. I am pleased to see that Ways and Means is taking steps to protect the family business.

I encourage you to repeal 2036(c) and replace it with rules that focus more closely on abusive situations and do not encompass valid transfers of the family business from one generation to the next.

Finally with estate tax rates at twice the individual income tax rates, I encourage you to direct Treasury to study the entire transfer tax system.

Thank you for the opportunity to express my comments to you.
[The statement of Mr. Benz follows:]

Testimony By

George B. Benz

Good afternoon, Mr. Chairman and members of the Committee. My name is George Benz. I am Vice President of American Bancorp, a small bank holding company in Minnesota and a Trustee of a Trust created by my grandparents more than 50 years ago which owns a controlling interest in American Bancorp. Either through direct ownership of American Bancorp or indirectly through the Trust, the decedents of my grandparents control approximately 80 percent of the stock of American Bancorp.

I would like to give you my comments regarding (1) the current estate tax freeze rules contained in section 2036(c) of the Internal Revenue Code and (2) the discussion draft of the bill to modify section 2036(c) which was issued by Chairman Rostenkowski on March 22, 1990.

First, with respect to the current estate freeze rules, it is my opinion that these rules should be repealed in their entirety, retroactive to the date of enactment (December 17, 1987). I understand that the intent of section 2036(c) was to prevent avoidance of transfer taxes. I heartily agree with this; however, I believe that better enforcement of existing rules should be sufficient to prevent avoidance of these taxes.

I would suggest that the Internal Revenue Service's burden of enforcing the transfer tax rules would be lessened through extensive reporting requirements. For this reason, I suggest that legislation which repeals IRC Section 2036(c) should impose reporting requirements irrespective of whether or not the taxpayer believes that transfer taxes are due or that a gift has occurred.

I believe that the concerns that have been raised by so many since the enactment of IRC Section 2036(c) can be resolved by repealing section 2036(c) retroactively and by enacting an expansive reporting requirement, replete with severe penalties for noncompliance. I strongly believe that the abuses Congress is attempting to curb can be curbed most cost effectively through better enforcement which can occur if these transactions are required to be reported, irrespective of whether or not transfer taxes are currently due.

Our tax laws do not need to be further burdened with complicated valuation and disproportionate transfer rules. Rather, existing rules, adequately enforced, are sufficient to protect the integrity of the transfer tax system. These types of issues are most efficiently resolved in a voluntary compliance system through adequate enforcement.

Assuming Congress wants to enact additional rules specifically relating to transfers with retained interests, the method by which Congress implemented the new rules in 1987

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is far too broad and unduly complex. I agree that a better approach is the one outlined in the Chairman's discussion draft. I believe that the discussion draft takes the right approach by addressing the allocation of value between family members, rather than taxing future appreciation to an individual no longer owning the property.

I am pleased to see that the approach in the new valuation rules is to tax the true value of transfers today and not to tax future appreciation in value by including the transferred property in the transferor's gross estate. The provision is intended to prevent undervaluation of the property transferred for gift tax purposes at the time of the transfer. As I previously indicated, it is important to prevent abusive transfers. However, the approach should not prevent intrafamily transfers at fair market value. To do so will inhibit growth and expansion of American business.

I am concerned that, as drafted, many existing arrangements will be unduly burdened by being required to become qualified fixed payments. In some cases, specifically my family, the interests owned by some individuals would not, and could not, be modified to become qualified fixed payments. Thus, the discussion draft effectively precludes transfers of any interests, other than a complete termination of the individual's interest.

Let me expand upon this point as I am sure you do not not intend to limit transfers between family members which are not designed to avoid transfer or income taxes. I am most concerned with the rules when property is held in an irrevocable trust whose investments are controlled by an independent trustee.

My concerns center around the restrictive definition of a qualified fixed payment and its affect on gift values. In our family situation existing trust arrangements will not result in qualified fixed payments and thus would be valued at zero when determining the amount of gift made to a family member. Even with a sale for fair market value, the retained interest would be valued at 0 forcing our family members to dispose of all interests or pay significant gift taxes on assets not transferred.

For example, our family members have a life interest in a trust which holds stock in American Bancorp. These family members also own stock directly in American Bancorp which may be periodically gifted or sold to other family members. Because the life interest is not a qualified fixed payment and because it cannot be modified to become a qualified fixed payment, that interest will be valued at zero. To determine

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any taxable gift, in the event of either a gift or a sale, the family member will, under the proposal, value all common stock held directly and the life interest in the irrevocable trust which holds the common stock and then determine an allocation of total value to the portion of such asset sold or gifted.

If we assume that the family member gives away all their American Bancorp common stock which is held outright and maintains only their life interest in the irrevocable trust which owns stock in American Bancorp, the value of the taxable gift will be the value of the stock gifted and the value of their life interest. A taxable gift has been created with respect to their life interest which was not given away. Because the life interest is valued at zero, nothing is owned now and the taxable gift is the total value of the common stock plus the life interest.

How could the committee correct this inequity in the proposed rules? A number of different approaches could be taken to correct this result. The easiest would be an effective date which provided that, for purposes of these rules, an arrangement existing on a specified date would be deemed to be an interest or arrangement which made qualified fixed payments. Alternatively, and a means of making the law more flexible, would be to provide that a person's "interest" in property is very narrowly defined and does not include interests which own the identical property.

I believe that any legislation using the discussion draft approach will effectively preclude or inappropriately tax some valid business transfers. If this is true, at least existing arrangements should be unaffected.

The current taxation of future appreciation on the proposed taxation of a nonqualified fixed payment with high estate tax rates (almost double the highest income tax rate), and the generation-skipping transfer tax effectively prevent the transfer of family-owned businesses from one generation to the next. The marital deduction and the unification of gift and estate taxes discourages transfers until the last survivor of a marriage has died. To pay taxes in an inflationary society will require the sale or liquidation of family businesses. This is clearly counter-productive from a business standpoint and will cause inefficiencies in the national economy.

Central to the free-enterprise system is the opportunity for individuals to build and create wealth for themselves and their families. This incentive is impeded and frustrated by an estate tax system which requires a family business that

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has been built over several generations to be taken apart to pay transfer taxes. This system effectively works as a disincentive to build and establish a successful closely held family business.

In conclusion, I am extremely pleased to see that Chairman Rostenkowski and the Ways and Means Committee has taken significant steps towards protecting a sacred American tradition, the closely held family business. I encourage the committee to continue its efforts to repeal section 2036(c) and replace it with rules that focus more closely on abusive situations and do not encompass valid transfers of the family business from one generation to the next. I believe rules regarding additional reporting should be sufficient. If not, rules as outlined in the discussion draft will be acceptable, assuming existing arrangements which do not result in qualified fixed payments are not valued at zero.

Finally, with estate tax rates at twice the individual income tax rates, I encourage you to direct Treasury to study the entire transfer tax system and its effect on this country's competitive advantage within the global economy. Assuming the committee determines that additional rules are needed beyond the repeal of section 2036(c) and beyond additional reporting requirements with severe penalties, I encourage you to consider postponing adoption of any such rules until after Treasury has completed a study of the entire transfer tax system and the affect upon family business in this country.

Thank you for the opportunity to express my comments to you.

George B. Benz

Chairman ROSTENKOWSKI. Mr. Reed.

Mr. CHANDLER. Mr. Chairman, I want to thank Mr. Reed for making this journey here. He represents a family-owned business in the State of Washington and other west coast States that is very important to our economy. I thought after talking with him that his perspective was a unique one being a resource-based and a renewable resource-based company.

I mention that point simply to highlight that fact of his testimony.

Also, you received, Mr. Chairman, a letter from Frank Blethen, Publisher and chief executive officer of the Seattle Times. I want to make sure that is part of the record. I believe the perspective of a newspaper owner will be useful to the committee as we consider this legislation.

Chairman ROSTENKOWSKI. Without objection.

Mr. Reed.

**STATEMENT OF WILLIAM G. REED, JR., CHAIRMAN, SIMPSON
TIMBER CO., SEATTLE, WA**

Mr. REED. Thank you, Mr. Chairman.

Mr. Chairman, members of the committee, my name is William G. Reed, Jr. Since 1962, I have worked for Simpson Timber Co. and been its chairman since 1971. Simpson is a family-owned forest products company begun by my great-grandfather in 1890. I am the fourth generation family member, and would like to think our ownership will continue into future generations.

The taxation burden and the complexities and uncertainties posed by section 2036(c) significantly lessen that possibility. I don't see how Simpson or any closely held company operating in an industry as competitive as pulp and paper and forest products can achieve the growth necessary to survive, and also afford the huge estate tax payments required.

Section 2036(c) is a provision that will leave the owners of Simpson with no better option than selling out, especially if the company is successful. To me, the section seems to penalize success. Not only is it bad for my family and Simpson, but I doubt such a policy makes sense for the country.

My experience tells me that closely-held companies can operate more efficiently and responsibly than firms with broad and diverse ownership. For instance, we are not hounded to produce successively better results each quarter, but can and do invest for the long term.

We are not encumbered by onerous SEC requirements, nor threatened by predatory shareholder suits and hostile takeovers which can virtually paralyze the management of widely owned firms.

In one area, we are at a distinct disadvantage. The fundamental resource, our capital for investment and growth cost the closely held company significantly more. Simply because we must raise these funds in the private placement market, our lenders are in a position to charge us from 100 to 150 basis points more than public companies who have wider and freer access to the capital markets.

Over the long run, considering compounding, this is a formidable obstacle made more so by the decapitalizing effect of 2036(c). Yet, Simpson has been successful. Since 1971, when my father retired, we have increased our sales nearly 10 times and our profits by a multiple of 36.

Much of this success has come from acquiring old and obsolete mills from much larger, broadly owned competitors like Weyerhaeuser, Champion International, and Kimberly Clark. We have succeeded in returning these mills to profitability where the large, widely owned previous owners had failed.

Ours has been a kind of entrepreneurial bootstrap management that was well-adapted to, and I think is characteristic of, the closely held family firm.

Under present law, it is unlikely that Simpson will be able to remain family owned over the long term. The changes under discussion do not help much. But while we favor repeal of 2036(c), we are certainly willing to consider alternatives and are open to them. But, we hope these can be as narrow, as simple and as clear as possible.

In addition to its economic problems, 2036(c) as it stands is so complicated and overly broad that not even our attorneys and accountants can clearly explain when and how it applies to our business transactions.

The replacement proposal may well create the same kinds of problems. There are numerous unanswered questions setting the stage for a renewed atmosphere of uncertainty and confusion as these experts try to advise their clients on how to proceed.

In one area, the proposal concerns me in a very personal way. My father died last October. He had not relied upon an abusive asset freeze technique to pass his interest along to me and my sisters.

We are planning accordingly for a redemption of his common stock to pay debt taxes. Should the proposed replacement proposal become law, the language makes the consequences of such a redemption unclear. Its interpretation depends upon regulation for clarifications that have not been written. This makes for an uncertain situation at a critical time for the family.

The best we can say about the replacement proposal is there may be less in it than is harmful to Simpson than is the case in 2036(c). Given a choice, we would probably elect to have the new proposal. However, we respectfully urge you to repeal the entire section 2036(c).

Finally, this year, Simpson is celebrating its centennial. As part of our normal operations, we are harvesting timber that began growing when my grandfather ran the company. We are also planting trees I hope my grandchildren will cut. Your actions on 2036(c) will largely determine whether this will happen.

[The statement of Mr. Reed follows:]

Testimony
for the Hearing of
the Ways and Means Committee
of the
U. S. House of Representatives
by
Wm. G. Reed, Jr., Chairman
Simpson Timber Company
Seattle, Washington

Tuesday, April 24, 1990

Mr. Chairman and Members of the Committee:

I am Wm. G. Reed, Jr., chairman of Simpson Timber Company, a family-held company engaged in growing and harvesting trees, and manufacturing and selling building products.

At the start, I wish to commend Chairman Rostenkowski for recognizing that some serious problems exist with Section 2036(c) of the Internal Revenue Code and for his willingness to have repeal or change of this section of current tax law considered by the Ways and Means Committee.

Simpson Timber Company is a medium-sized company in our industry. We own about 765,000 acres of timberlands in Washington, Oregon and California. Our 2,400 employees produce lumber, plywood and doors in 12 manufacturing plants in 7 West Coast communities. The company is an important part of the economy in most of those cities. Our products are marketed nationally and internationally.

Trees are the heart of Simpson's business. We are harvesting our second forest and planting our third, assuring a perpetual supply of wood products. Simpson plants seedlings immediately after an area is harvested, and our records show that 85 million seedlings have been planted in California and Washington since 1943.

Simpson tree farms benefit the environment. They produce needed oxygen and clean water, are home for wildlife, and when and where possible, are open for public recreation. Fish habitat is a very special interest and avocation of mine, and I'm pleased to report that fish and timber harvesting can and do coexist on Simpson lands and in much of the forest products industry.

We have worked very hard to be good corporate citizens in the mostly rural communities where our operations are located. The Mark E. Reed Scholarship Program, named after my grandfather, has awarded 1,027 college scholarships to young people at a cost of \$787,300, since the program started in 1947.

Our charitable contributions to health and human services, education, culture and the arts, and civic causes, through the Matlock Foundation and corporate giving, have totaled \$12,800,000 since 1976, when completed records were available.

And the company has provided tens of thousands of jobs, billions of dollars of payroll, and millions of dollars of tax payments throughout its 100-year history.

This year, 1990, is the Simpson Centennial and we're celebrating throughout our operations the stewardship of the owners and employees who have brought the company through the first 100 years.

My great-grandfather, Sol Simpson, founded the company in Southwest Washington State in 1890, as we say with "50 men and 12 horses." I represent the fourth generation of ownership and some of the children of my generation--those being the fifth generation--have completed their education and are starting with the company. They are preparing to continue the business.

Before addressing Section 2036(c), it might be useful to address the merits of family-owned businesses, because this section of law has made it difficult to plan lifetime transfers of interest in family enterprises.

Family businesses have advantages and disadvantages, and Simpson has experienced both over the last century. However, they seem to offer some very real benefits to society and to the environment. Let me see if I can explain:

Growing trees for timber as a crop is a long-term business. It takes 50-60 years to grow a crop of Douglas fir, western hemlock or coastal redwood to maturity.

In general, I believe family businesses can be more interested in long-term goals rather than short-term profits. We don't have a vast number of uninvolved stockholders primarily seeking immediate return on investment.

Since we plan to continue Simpson as a family business, the concept of sustained yield has special meaning to us. We operate on the basis that trees are a renewable resource, and that we will manage our lands for continuous production of timber, now and in the future. It is not by accident that there are more trees growing today on the original Simpson lands than there were when the company first became a landowner in 1895.

Today, in the era of LBO's, there have been many takeovers of what had been well-managed timberlands, with the result in some instances of an increase in harvest rate to service the debt. This situation isn't likely to occur with family businesses, and public policy, it seems to me, should encourage family businesses to be passed on from generation to generation.

Current law, with Section 2036(c), in its effort to correct the estate tax "freeze," is so far-reaching that many nonabusive business transactions--particularly ones between family members--are caught in the net. The result is added taxes that inhibit the ability to, or increase the costs of, continuing to maintain the family business. Family businesses are then forced to go public, local control and focus is lost, and some of the social and environmental benefits in the forest management sense are placed at risk.

Under present law, it is unlikely Simpson will be able to remain family-owned over the long term.

While our family favors repeal, family businesses are willing to consider alternatives, but we hope these can be as narrow, as simple, and as clear as possible. In addition to its economic problems, 2036(c) is so complicated and overly broad that not even our attorneys or accountants can clearly explain when and how it applies to our business transactions.

The replacement proposal may well create the same kinds of problems we have seen with Section 2036(c). There are numerous unanswered questions, setting the stage for a renewed atmosphere of uncertainty and confusion as these experts try to advise their clients on how to proceed.

One specific concern with the proposal has been brought to my attention in a very personal sense. My father died last October after a long illness. At the present time, we are planning for a redemption of stock to pay his death taxes. Should the proposed replacement to Section 2036(c) become law, the language makes it unclear as to the consequence of a redemption to provide funds to pay death taxes and is dependent upon regulations for clarification. This makes an uncertain situation for us.

The best we can say about the proposal is that there may be less in it which is harmful to Simpson than is in Section 2036(c). Given a choice, we would probably elect to have the new proposal. However, we respectfully urge you to repeal the entire Section 2036(c). Period.

I appreciate the opportunity to testify. If you have any questions, I'll be pleased to respond.

Chairman ROSTENKOWSKI, Mr. McKenney.

STATEMENT OF DAVID MCKENNEY, PRESIDENT, MCKENNEY'S, INC., ATLANTA, GA, REPRESENTING THE SHEET METAL & AIR CONDITIONING CONTRACTORS' NATIONAL ASSOCIATION, INC.

Mr. McKENNEY. I am David McKenney, president of McKenney's Inc., a second-generation air-conditioning and mechanical contracting firm in Atlanta, GA. Thank you for this opportunity to appear before you on behalf of the Sheet Metal & Air Conditioning Contractors, SMACNA, and its 5,000 contributing contractors. My testimony is an abbreviated version of SMACNA's written statement, which has been provided to the committee.

SMACNA's membership is composed primarily of small family-owned, highly entrepreneurial firms. Section 2036(c) was an unwelcome surprise to SMACNA members and a cause of grave concern to the small business community in general, and especially in our industry where pride of building a business and transferring it to the next generation is a tradition, a tradition that represents an essential element of this Nation's free enterprise system.

SMACNA supports repeal of section 2036(c) and other tax provisions unfairly limiting or hindering transfers of family business ownership between generations. This law eliminates the legitimate estate freeze technique, which our company used in 1975 to pass ownership and control of our business from my parents to me.

For a number of years, quarterly dividends on that preferred stock helped provide funds for my parents' retirement. Recently, that stock became the bulk of my sister's inheritance. The dividends are an important part of her family's standard of living.

We applaud the effort taken in the discussion draft to focus on the abuses which may have occurred under prior law, and to continue to allow legitimate transfers. It is critically important not to allow the end product of your deliberations to penalize family businesses which need sufficient cash to survive.

The vast majority of family owned construction businesses are not highly capitalized. Under section 2036(c), the assessment of large tax liabilities on newly purchased or inherited companies limits their ability to borrow, to obtain bonds and to acquire new work which will ultimately result in failure for many contractors.

In addition, IRS regulations for section 2036(c) have broadened the law's restrictions to include any estate properly passed from parent to child that might appreciate substantially and in which the parent might have a stake.

This undermines the ability of generations to work and prosper side by side in their family business, and threatens their very existence. As a representative of an industry which reflects the entrepreneurial heritage of the American worker who puts down his tools, starts a business and if he becomes successful, dreams of passing the business onto future generations, I believe the current discussion draft is a vital first step in the process of modifying current estate valuation law.

We look forward to the opportunity to provide further constructive input into the process of turning this draft into a law which ends flagrant abuses while promoting the opportunity for contin-

ued operation of family owned construction firms, family farms and other family businesses.

SMACNA supports the recommendation to repeal 2036(c) retroactively. We believe that the approach of establishing the value of qualified fixed payments is basically sound. SMACNA believes the flexibility in the provisions concerning qualified fixed payments, especially the 3-year grace period and bankruptcy/insolvency exception, are helpful, but we believe further consideration of other special business circumstance exemptions would be useful.

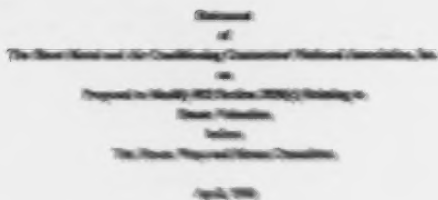
SMACNA is concerned about the up-front taxes on gifts. Under some conditions, it appears that some owners could be in worse shape than under current law. We see potential problems with the practical application of valuation rules. We encourage the committee to consider more clearly outlining valuation guidelines.

Repealing IRS section 2036(c) is a must. While eliminating abuse is important, returning to more nearly pre-1987 estate transfer rules is essential to the survival of family owned businesses, especially now that small businesses are being recognized as the fastest-growing provider of jobs in our economy.

We look forward to the opportunity to assist in this effort. Thank you for your attention.

[The statement of Mr. McKenney follows.]

The Sheet Metal and Air Conditioning Contractors' National Association, Inc.



SHACNA is an international trade association representing 3,000 commercial, contract air conditioning and heating air conditioning, air conditioning contractors, and related services organizations, and their interests in the sheet metal and air conditioning industry.

The sheet metal contracting industry exceeds \$10 billion annually.



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PROPOSAL TO REPEAL IRS SECTION 2036(c) RETROACTIVE VALUATION FREEZE

The Sheet Metal and Air Conditioning Contractors' National Association, Inc. (SMACNA), representing more than 1,000 construction firms, believes that modifications to the current estate valuation law (IRS Section 2036(c)) is essential to the survival of family owned and operated businesses.

SMACNA's membership is primarily composed of family owned businesses. The the legislation and IRS regulations were an unanticipated and unwelcome surprise to SMACNA members. The new burdensome Omnibus Budget Reconciliation Act in the small business community, transferring it to the next generation is a tradition. Family owned businesses represent an essential element of this nation's capitalist system.

SMACNA'S POSITION

SMACNA supports repeal of IRS Section 2036(c) and other tax provisions unfairly limiting or hindering family business transfers of ownership between generations. We urge Congress and the nation's political leadership to aggressively support the creation and capitalization of family owned businesses. Statement of family owned businesses. nation's economic system and social structure.

Current law eliminates some of the most commonly used, legitimate methods of passing a family business from one generation to the next with associated transactions and abusive transfers treated equally. Modifications should focus on abuses and should not penalize family businesses which need sufficient cash to survive. The vast majority of family owned construction businesses are not highly capitalized. The new restriction to include any estate will ultimately result in failure. In many cases, the parent might have a child who might appreciate the business and in which the parent might have a child. The restrictions on ability of generations to work and prosper will be a threat to the construction industry and threatens the very existence of businesses.

Not only has Section 2036(c) eliminated the estate freeze, but it has also called into question the legality of numerous other intra-family transfers. It also discourages many to determine which intra-family transfers are covered by a law which we do not want. When small businesses are not tax attorneys and business partners are covered by the law and the level of harm is vast.

SMACNA believes that Section 2036(c) of the Internal Revenue Code requires family businesses to dissolve their firms and discourage the formation of new construction businesses. It also discourages many normal intra-family transactions involving family businesses and investment arrangements. Such action results because an individual's family could be subject to huge taxes if the individual: 1) Gives or sells (even for fair market value) an interest in a corporation to partnership (or other enterprise) to his or her child (or other family member); 2) is a retired employee of a corporation in which the child has an interest; 3) enters into a buy/sell agreement with the corporation or partnership containing a formula purchase price (which traditionally has been respected) if the individual's child is also a shareholder or partner—even though the same agreement would not give rise to any such tax if all the shareholders or partners were non-family members; 4) hires a child to work in a family business if that business contains an ESOP (employee stock ownership plan); or 5) starts a new business with his or her child.

The following example is one that could easily occur in our industry:

- Owner of construction firm sells company to son.
- 10 years later father/owner dies.
- Company's value at time of father's death is 5-10 times greater than at sell date even though father owned no stock in company.
- Son is liable for the portion of taxes that the company represents. With top effective state tax rate of 55 percent, son cannot raise cash for taxes.
- Son sells company, dissolves business for tax purposes.

These taxes could be as high as 55% of the appreciation in the value of the business from the date of the event described above to the individual's death, even if this appreciation is attributable to the direct efforts of the heir over a long period of time. A son or daughter could be required to pay this tax at the death of a parent even though the child may have originally purchased the interest in the business from the parent for fair market value. These taxes could also be payable on a lifetime sale of the business to outsiders, in addition to capital gains taxes.

DISCUSSION DRAFT

SMACNA believes the path to returning to pre-1986 and 1987 estate tax law will be a lengthy one that involves many proposals to meet the concerns of the Congress, Treasury and the small business community. We believe the current discussion draft is a vital first step in that process.

First, we support the draft's recommendation to repeal Section 2036(c) retroactively. No evidence exists that SMACNA's members or the sheet metal industry have abused estate freeze transaction. SMACNA is not persuaded that either the draft proposal or current law is necessary. The draft should be narrowed to deal only with present past abuses and not become an omnibus estate reform package penalizing family businesses.

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April, 1990

Second, the flexibility in the provisions concerning deemed gifts unpaid qualified fixed payments (QFF) are helpful. While a special business circumstances exception would be useful in determining whether gift tax penalties are due, the draft's "deemed gift" rule exemption if the QFF is paid within three years is an acceptable alternative. Simple fairness warrants inclusion of insolvency and bankruptcy provisions in any final bill. We also support the provisions for a creditable or refundable gift tax where a QFF is paid after gift taxes have been collected. However, it does not appear equitable to apply the deemed gift rules when the benefit accrues to a non-family member.

Third, QFF's which would be allowed under the draft proposal, would be taxed as a gift and, in the form of a preferred dividend, as a dividend. This double taxation over the years could exceed the present estate tax. Because income on preferred stock is non-deductible to a business, a rate lower than the applicable federal rate should be used on the double taxation on the preferred stock dividends. New legislation should address this potential penalty for business owners who want to pass their business to family members. This limits the ability of businesses to grow by discouraging the issuance of dividends. This burden and the existing Section 2036(c) have required many companies to conduct "sideways" sales.

Fourth, another concern is the up-front taxes on gifts. If taxes on gifts are levied earlier than they are under Section 2036(c), some owners may be in worse shape under the new draft proposal than current law.

Fifth, problems with the valuations rule in the draft proposal are twofold:

- Using market testing rates (i.e. current market rate, higher than applicable federal rates (AFR)) discriminates against family businesses such as construction firms typified with low capitalization and by poor cash flow in favor of other non-family firms with more positive cash flow. It also artificially boosts the value of common stock held by heirs thus penalizing holders indirectly and increasing gift taxes on the parents.
- Leases and debt are treated as equity for family held businesses though treated differently in publicly held corporations.

In summary, the draft proposal does not modify current law in as favorable a manner as is necessary to maintain continued operation of family owned construction firms. The proposal misses the opportunity to enhance the financial strength of family businesses by easing rules for valuation, expanding safe-harbors and family interest and participation. Further, the proposed up-front gift tax on cash poor small businesses may offset the value of the positive provisions mentioned earlier. Construction firms will suffer a great deal from this particular provision.

FAMILY OWNED BUSINESSES AT RISK

The most disconcerting fact about the IRS Section 2036(c) is the process by which it became law. There were no hearings on an issue of this great importance. Somehow, somewhere in the Halls of Congress, the appreciation of our country's traditional heritage seems to have been lost. Instead of encouraging individuals to form enterprises, build enterprises and pass those economic engines onto sons and daughters or other family members, there appears to be a presumption that no tradition has significant value when it concerns the small business community or in resolving the budget deficit problem. It is distressing to most Americans when any small business is forced to close its doors for the last time after generations of operation, whether it is a family construction firm or family farm especially if it has to close because of being unable to afford estate taxes. In stead of providing subsidies for faltering businesses, Congress should provide more incentives for preserving successful family business and nurturing new businesses. We would hope that Congress would demonstrate greater concern for the present difficulties of operating small businesses by repealing the current estate tax penalty of Section 2036(c).

Is the collecting tax revenue today from 2036(c) more important than the millions of family owned businesses creating employment and paying taxes now, tomorrow and in the future? Is there some new danger or change in values which has resulted in a conclusion that the creation and transfer of family-owned businesses to sons, daughters or other family members is so inherently bad that the traditional intergenerational economic process should be interrupted by inequitable and burdensome tax policy? Is it proper social, economic or tax policy to refuse a parent the right to retain a minute interest in his child's new business as a coach or consultant to share his life's experience without full retirement?

CONCLUSION

Repealing IRS Section 2036(c) and returning to pre-1987 estate rules is an important first step to convincing existing family owned businesses and those contemplating forming small businesses that Congress supports them.

STATEMENT OF PAUL B. HORSEY, SR., OWNER, WILLIAMS WAYSIDE FURNITURE, SPRINGFIELD, VA, ON BEHALF OF THE NATIONAL HOME FURNISHINGS ASSOCIATION

Mr. HORSEY. On behalf of the National Home Furnishings Association, I appreciate this opportunity to testify on the subject of Internal Revenue Code section 2036(c). My name is Paul B. Horsey, Sr. My business is Williams Wayside Furniture, a family owned retail furniture business in Springfield, Virginia.

My training started 45 years ago working in and learning the retail furniture business from a family owner and fine teacher in Bridgeville, DE. That company, Scott's Furniture, has a third-generation serving the Eastern Shore of Maryland and Delaware.

I also wanted a family owned furniture business. Thirty-three years ago, I moved to Virginia and have operated a family business since. Now, our desire is that our family business will be around another 33 years and longer, hopefully.

Our general manager, my son Bobby Horsey, Jr., now aged 40, also wants to continue Williams Wayside Furniture for another 33 years or more, but is very concerned about whether the funds will be available to grow the business after my death under the present family owned business tax structure and unpredictable economic future.

The National Home Furnishings Association is the principal trade association for the home furnishing retailers. Founded in 1919 by five retailers, it now has the strength of over 3,500 member companies, representing 13,000 individual stores in all 50 States and Canada. While we represent retailers of all sizes and shapes, the classic member is the independently owned, family owned Main Street retailer. In fact, third and fourth generation ownership is not unusual in our industry.

As a result, we have a keen interest in any problem that involves business continuity. Our speculation is that close to 75 percent of businesses in our Nation are family owned and operated.

Section 2036(c) generated two specific problems. The first type is created by its inartful drafting. The drafting raised red flags. We were told, be careful of the consequences of intrafamily transactions. They may have estate tax consequences. The long and short of it is that section 2036(c) has had a chilling effect on the business continuity plan of many family owned businesses. Families who have never considered a fancy recapitalization face the inadvertent landmines of section 2036(c).

The second set of problems stem from the desire of the successful family business to effect a transfer of the business without triggering a fatal cash-flow crisis. In that scenario, section 2036(c) was simply unfair. While it has shut the door on the theoretic abuse, it puts a heavy price on any effort to transfer a business.

There are land mines that might explode on the family owned business not seeking to recapitalize a business. With regard to the committee's proposal, we can tell you that at least one has pointed out to us, and we are sure there are more. The proposal apparently attempts to regulate buy-sell agreements. If there is anything synonymous with family owned businesses, it is buy-sell agreements. Buy-sell agreements are established for many nontax, and I state,

nontax reasons. The most compelling of which is to keep the peace. Any family business adviser will tell you that even in the most harmonious of families, transfer of the business invariably generates feelings from uneasiness to outright viciousness.

An example where the buy-sell agreement comes in handy is when the second generation consists of both active and passive siblings, that is, one child who will run the business while the others pursue other careers. It is best settled up front.

We can tell you that if the buy-sell language remains, you have done nothing to reduce the anxiety levels of millions of family owned businesses that would otherwise never become aware of this section of the law.

For those businesses desiring to effect a transfer, a second litmus test is whether the replacement rules provide for certainty and are fair. There are two dozen different issues that can be raised.

We thank you for this opportunity to testify.

[The statement of Mr. Horsey follows:]

TESTIMONY OF

Paul B. Horsey, Sr., Williams Wayside Furniture

on Behalf of the

National Home Furnishings Association

On behalf of the National Home Furnishings Association, I appreciate this opportunity to testify on the subject of Internal Revenue Code Section 2036(c). NHFA is the principal trade association for the home furnishings retailer. Founded in 1919 with five retailers, NHFA now has the strength of more than 3,500 member companies, representing 13,000 individual stores in all 50 states and Canada. While we represent retailers of all sizes and shapes, the "classic" member is the independently-owned, family-owned, main street retailer. In fact, third and fourth generation ownership is not unusual in our industry. As a result, we have a keen interest in any problem that involves business continuity concerns. My name is Paul B. Horsey, Sr., and my business, Williams Wayside Furniture in Springfield, Virginia, is one such family-owned business.

At the outset, we would like to acknowledge the open and forthright manner in which Assistant Secretary of Treasury Ken Gideon, the Chairman, and this Committee have worked with the business community to resolve the problems created by enactment of Internal Revenue Code Section 2036(c). The experience has been a positive one, and bodes well for the development of sound economic policy. It is also appropriate to acknowledge the efforts of Representative Archer, who has worked diligently from the beginning to bring this matter to the attention of his colleagues.

Some general observations about the health of family-owned businesses are in order before we comment on the specifics of Section 2036(c) and the draft replacement proposal on the table.

No one can produce reliable statistics on how many family-owned businesses we have in this country. We have seen figures that claim 95 percent of all businesses are family-owned. We suspect the number of family-owned businesses, in the truest sense of family-owned and operated, is closer to 75 percent, but that is speculation. Either way, intuitively, we all know that if independent, small business is the backbone of our economy, the family-owned business provides the economic and social stability essential to our continued growth and prosperity.

It seems ironic to us, then, that not only does our nation not have a national policy to encourage family ownership, we continue to place obstacles in the path of family ownership. Mergers and acquisitions are consummated for a variety of reasons, and it is unfair to single out one, but we can tell you this: Confronted with complex regulatory and tax schemes, when the regional holding company comes around and offers the independent family-owned business cash that can become the retirement fund for one generation, and the seed fund for the next, another day with the government's intrusions seldom seems worth it.

In particular, the tax code is weighted heavily against family-owned business. One example is the employee benefit section of the code. Built into the system is a presumption that any benefit provided to a family member is suspect and, therefore, must meet a higher standard.

The estate and gift tax system is the most glaring example of a policy counterproductive to the continuity of the family-owned business. Almost by definition, if you are a successful family-owned business, you are most vulnerable to the penalties of the system. Most family-owned businesses begin with the hard work of the first generation and few other assets. Sweat equity is often the only equity. If the business is successful, by the time the business is in the hands of a third generation, the appreciation, in relative terms, is significant. When you are starting with a zero basis, the appreciation adds up.

But yet, if the business is successful, it is not likely to be value that can be tapped to the benefit of individuals. The appreciation is in its operating assets and its goodwill. There is seldom an account in a bank with a healthy balance of retained earnings, and there is certainly not a market for the securities of the company.

The transfer of a successful family-owned business looks like the transfer of wealth on paper; but in the end, it is nothing more than the transfer of the original sweat equity.

What happens when estate taxes must be paid? Liquidation. First, you look to see are there any parts of the business we can sell off. Can we sell off the floorcovering portion of the business or the TV-entertainment

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center division and go back to basic furniture retailing? The second choice: Is there an asset we can sell? Can we get by with one warehouse and sell the other? In the end, maybe the cash to pay the taxes will be raised, but only by altering the nature of the business. Is this what we want to accomplish with our tax policy? We think not.

All of which brings us to Section 2036(c). With all due respect to its authors, we have to believe it was drafted on the basis of what they read in the newspapers, rather than what goes on in the real world of family-owned businesses. It gives us some pause for concern that we must have statutes this complex for the purpose of preventing activities that, in 99.9 percent of the cases, are only theoretically possible.

Putting aside the philosophical debate over the impact of estate taxes on family businesses, Section 2036(c) generated two specific problems, and any proposal to replace it will be judged by the same litmus tests. The first type of problem was created by its "inartful" drafting. The language of Section 2036(c) raised red flags in the course of the routine business of a family-owned business. We were told "be careful of the consequences of any intra-family transaction, it may have estate tax consequences." The long and short of it is that Section 2036(c) has had a chilling effect on the business continuity plans of many family-owned businesses. Families who had never considered a "fancy" recapitalization, faced the inadvertent land mines of Section 2036(c). The second set of problems stem from the desire of successful family-owned businesses to effect a transfer of the business without triggering a fatal cash-flow crisis. In that scenario, Section 2036(c) was simply unfair. While it may have shut the door on theoretical abuse, it put a heavy price on any effort to transfer a business.

We must confess, the replacement proposal frightens us somewhat. It strikes us as another attempt to solve many problems, however unlikely they might be. Nevertheless, we are willing to explore whether a proposal can be crafted to handle the proven abuses without doing unnecessary damage to the family-owned sector of the economy.

It is not possible for us to tell you what "t's" must be crossed or "i's" dotted, but we can go back to our two litmus tests and urge you to apply them to any proposal.

First, are there any land mines that might explode on the family-owned business not seeking to recapitalize the business? With regard to the Committee's proposal, we can tell you that at least one has been pointed out to us, and we are sure there are more.

The proposal apparently attempts to regulate buy-sell agreements. If there is one thing synonymous with family-owned businesses, it is a buy-sell agreement. Buy-sell agreements are established for many non-tax reasons, the most compelling of which is to keep the peace. Any family business advisor will tell you that even in the most harmonious of families, transfer of the business invariably generates feelings ranging from uneasiness to outright bitterness. The classic example of where a buy-sell agreement comes in handy is when the second generation consists of both active and passive siblings, that is, one child who will run the business, while the others pursue different careers. Who gets the family business and on what terms is best settled up front.

We can tell you if the buy-sell language remains, you have done nothing to reduce the anxiety levels of millions of family-owned businesses that would otherwise never become aware of this law.

For those businesses desiring to effect a transfer, a second litmus test is whether the replacement rules provide for certainty and are they fair? From what we have heard, there are some two dozen different issues that can be raised under this test.

By way of example, we can offer one issue. If a family chooses to recapitalize and follows the structure of the replacement proposal, the business will be obligated to make "qualified fixed payments," or QFPs. If it fails to make the payments, it may trigger gift tax consequences. Yet, the proposal provides relief from the consequences of a failure to make the

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QEPs only in the case of insolvency or bankruptcy. We would argue that a fair rule should provide a hardship exception that permits relief in the event of long-term deteriorating economic conditions. We think we all want to give such businesses a chance to survive.

While we believe we could make a compelling argument that the estate and gift tax system, as a whole, is a disincentive to continuity of a family-owned business, it is a debate for another day. If we must live within the current system, we do not need such legislation as Section 2036(c) to exacerbate the decline of family-owned businesses. We will try to work with you to craft a solution to meet everyone's needs. We hope it can be based on a presumption that family-ownership should be encouraged.

We thank you for this opportunity to testify.

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Chairman ROSTENKOWSKI. Thank you.
Mr. Weber.

STATEMENT OF LEO WEBER, MEMBER OF THE BOARD, ASSOCIATED SPECIALTY CONTRACTORS; PRESIDENT, NATIONAL ELECTRICAL CONTRACTORS ASSOCIATION; AND PRESIDENT, WEBER ELECTRIC INC., ST. PAUL, MN

Mr. WEBER. Good afternoon.

My name is Leo Weber. I am an electrical contractor in St. Paul. I am also president of the National Electrical Contractors Association.

It is a pleasure to testify before you today on behalf of the Associated Specialty Contractors.

The Associated Speciality Contractors is a coalition of eight national associations with combined membership totals about 25,000 firms.

On a construction site, the speciality contractors represented by these groups do up to 80 percent of the work. Like other construction business owners, I spent many long years in training before I became an independent businessman. In 1942, I received my first training in electricity from the Navy. After serving in both European and Pacific theaters, I returned to St. Paul and joined a NECA/IBEW apprenticeship program. From 1949 to 1960, I moved up from a journeyman to a general foreman and in 1960, I decided I wanted to be my own boss. I borrowed \$10,000 from a friend, purchased three used trucks, rented space in an old butcher shop and opened up Weber Electric.

During my first year as a small business owner, Weber Electric had two electricians, and a total sales of \$275,000. Last year after 30 years of hard work, my firm worked an average field crew of 50 electricians and had sales in excess of \$6 million. Not only has my business grown over the past years, but so has my family. I have eight children and 13 grandchildren. Two of my sons work for Weber Electric and my youngest son is currently in the apprenticeship training.

The provisions of section 2036(c) now in the law discourage and probably prohibit my sons and other members of my family from carrying on Weber Electric in its present form. These rules will force many family business owners to sell their business to nonfamily members. If the business has appreciated considerably, as mine, it will force the children who will inherit the business either to sell the company or liquidate a large part of the assets of the company to pay estate taxes.

I realize that section 2036 was passed to close an estate planning loophole, however, in an effort to stop abuses, Congress enacted an estate tax system, which severely punishes contractors like myself who have devoted a lifetime building a company and reputation to leave behind.

Unfortunately, as a result of the individual's success, his children will not be able to afford to carry on the family business because of this law.

One of the most valuable assets of a construction contractor is his bonding capacity. Bonding companies require financial statements when determining whether or not they will grant a bond to

a contractor and in what amount. Construction contractors normally maintain very little inventory and, therefore, are determined to be financially sound on the basis of the return in earnings or their work in progress.

In fact, today most bonding companies require contractors to leave the majority of their final assets, financial assets in their business cash reserves. When assets have to be sold to pay the taxes, the contractor's bonding capacity could be greatly diminished. The result is a loss of his ability to get the bonding in to compete for work.

One of the most valuable assets of a construction contractor is the name and personal reputation of the owner and his family. Success for a small business enterprise may depend on continuing that family ownership. Yet the current law actually discourages the transfer of ownership to another member of the family.

I am grateful to this committee for recognizing that some modification of this provision is required. If given a choice, we could, we would like to see a simple repeal of the estate tax valuation. However, we also understand the feeling of Congress that certain abuses need to be eliminated.

We have reviewed our discussion draft to replace section 2036(c) with an alternative and I believe this course is the first step on the way to an acceptable compromise.

I am an electrical contractor. I am sure that I do not grasp all the details and shades of meaning apparent to accountants and tax attorneys. However, the draft appears to consider some good news and some bad news.

The good news is that the draft sets a valuation of the transferred property at the time of the transfer. This is extremely important. To us it is the centerpiece of this proposal.

The bad news is that the draft appears to affect many types of transactions that were not part of the problem.

We would like to see complete repeal of 2036 (c). Language is a starting point.

The committee should then adopt a solution that uses more of a rifle shot than a short gun approach. We hate to see a bill which solves one problem but which would create others that would hurt small family owned businesses.

For example, it is not clear whether some of the portions of the property being transferred would be subject to both an estate and a gift tax. It also appears possible that the handling of indebtedness might result in double taxation of a portion of the value of the business being transferred.

The deemed gift rule also appears to be too broad. For example, it could be imposed on nonfamily equity owners.

To summarize, the current law has created a nightmare in the minds of accountants and the heart of construction contractors throughout the country.

The current law on estate tax valuations must be repealed. It nearly prevents a working fiscally sound business from being passed from one generation to another. Should it be necessary to replace the repealed law with something else, the draft legislation is a responsible starting point. But it needs a great deal more detailed work.

Thank you for allowing me on behalf of the Associated Speciality Contractors to present our views on this issue.

Thank you.

[The statement of Mr. Weber follows:]

STATEMENT BY LEO WEBER
FOR THE
ASSOCIATED SPECIALTY CONTRACTORS
BEFORE
THE HOUSE WAYS AND MEANS COMMITTEE
ON A COMMITTEE DISCUSSION DRAFT
RELATING TO ESTATE VALUATION FREEZES

APRIL 24, 1980

Good afternoon, my name is Leo Weber. I am the President of Weber Electric Inc, an electrical contracting firm located in St. Paul, Minnesota. I am also the President of the National Electrical Contractors Association (NECA).

It is a pleasure to testify before you today on behalf of the Associated Specialty Contractors (ASC). The Associated Specialty Contractors is a coalition of eight national associations whose combined membership totals about 25,000 firms. On a construction site the specialty contractors represented by these groups do up to 80% of the total work.

I am very pleased that your Committee has decided to hold hearings on section 2036(c) of the Internal Revenue Code relating to estate valuation freezes. As presently written this provision not only penalizes my company and my family, but many other similar construction companies.

BUSINESS SUCCESS DOES NOT ALWAYS COME QUICKLY

Like many construction business owners, I spent many long years in training before I became an entrepreneur. In 1942 I received my first training in electricity from the Navy. After serving in both the European and Pacific theaters, I returned to St. Paul and joined a NECA/IBEW apprenticeship training program. From 1949 to 1960 I moved up from journeyman to general foreman and in 1960 I decided I wanted to be my own boss.

I borrowed \$10,000 from a friend, purchased three used trucks, rented space in a old butcher shop, and opened up Weber Electric Inc. During my first year as a small business owner, Weber Electric had two electricians and a total sales of \$275,000. Last year, after 30 years of hard work, my firm worked an average field crew of 50, and had sales in excess of \$6 million.

Not only has my business grown over the past 30 years but so has my family. I have eight children and 13 grandchildren. Two of my sons work for Weber Electric, and my youngest son is currently undergoing apprenticeship training.

I fear, however, that the broad and complex provisions of section 2036(c) will discourage and probably prohibit my sons and other members of my family from carrying on Weber Electric in its present form.

SECTION 2036(c) DISCOURAGES ENTREPRENEURSHIP

Most family business owners, myself included, have made provisions for passing their business onto their other family members. We have hired financial planners to structure our business and our holdings in such a manner to facilitate the transfer of our property to our heirs. We have done this planning not as a means of subverting the law or avoiding taxation, but so that our heirs for generations to come, will be prepared to continue the family business.

However, as presently written, section 2036(c) will force many family business owners to sell their business to non-family members. If the business has appreciated considerably, as has mine, it will force heirs either to sell the company or liquidate large assets of the company to the pay estate taxes.

I realize that Section 2036(c) was initially enacted to close an estate planning tax "loophole". In an effort to curtail the practices of the abusers, Congress enacted an estate tax system which severely punishes contractors like myself who have devoted a lifetime building a company and a reputation to leave behind. Unfortunately, as a result of an individual's success, his children will not be able to afford to carry on the family business because of this law.

SECTION 2036(c) IMPACTS BONDING CAPACITY

One of the most valuable assets of a construction contractor is bonding capacity. Bonding companies require financial statements when determining whether or not they will grant a bond to a contractor, and in what amount.

Construction contractors normally maintain very little inventory, and therefore, are determined to be financially sound on the basis of their retained earnings or their work in progress. In fact, today, most bonding companies require contractors to leave the majority of their financial assets in their businesses cash reserves.

As a result of section 2036(c), heirs to businesses may be required to take money out of the business in order to pay the estate tax. If this occurs, a contractors bonding capacity could be greatly diminished resulting in a loss in his ability to get the level of bonding needed to compete for work.

A COMPANY'S WORTH CAN BE DETERMINED BY A NAME

One of the most valuable assets of a construction contractor is the name and personal reputation of the owner. Ongoing success for a small business may depend on continuity of family ownership. Section 2036(c) discourages the transfer of ownership to another member of a family.

One of the major reasons that Weber Electric continues to be a healthy contracting business in the 90's is my insistence on providing superior service to established customers. I have cultivated relationships with particular contractors and owners. My company has developed a reputation for doing our work on time. It has taken me 30 years to build this reputation and to lay this groundwork for my sons. If my sons were forced to sell my company and start a new business from scratch there would not be much to show for this lifetime of commitment to Weber Electric.

A PROPOSAL FOR A NEW SECTION 2036(c)

As you can see, section 2036(c) in its present form provides many problems for the family-owned construction business. I am grateful to this committee for recognizing that some modification of this provision is required. If given a choice we could like to see a simple repeal of estate tax valuation provisions of 2036(c).

However, we also understand the feeling of Congress that certain abuses need to be eliminated. We have reviewed your "discussion draft" to modify section 2036(c) and believe that this alternative appears to us to be the first step on the way to an acceptable compromise.

I am an electrical contractor, not a tax expert. I am sure I do not grasp all the subtleties apparent to accountants and tax attorneys. However, the draft appears to contain some good news and some bad news.

The good news is that the draft sets valuation of the transferred property at the time of the transfer. This is extremely important. To us it is the centerpiece of the proposal.

The bad news is that the draft appears to affect many types of transactions that were not part of the problem. We would like to see complete repeal of the 2036(c) language as a starting point. The Committee should then adopt a solution that uses more of a rifle shot than a shotgun approach.

We would hate to see a bill which solves this problem, but which would create others that would hurt small, family-owned businesses. For example, it is not clear whether some portions of the property being transferred would be subject to both an estate and a gift tax.

It also appears possible that the handling of indebtedness might result in double taxation of a portion of the value of the business being transferred. The "deemed gift" rule also appears to be too broad. For example, it could be imposed on non-family equity holders.

CONCLUSION

To summarize, current law has created a nightmare in the minds of accountants and in the hearts of construction contractors throughout the country. The current law on estate tax valuation must be repealed. It nearly prevents a working, fiscally sound small business from being passed from one generation to another.

Should it be necessary to replace the repealed law with something else, the draft legislation is a responsible starting point. But it needs a great deal more detail work.

Thank you for allowing the Associated Specialty Contractors to present our views on this issue.

MEMBERS OF THE ASSOCIATED SPECIALTY CONTRACTORS

Mason Contractors Association of America
Mechanical Contractors Association of America
National Association of Plumbing, Heating and Cooling Contractors
National Electrical Contractors Association
National Insulation and Abatement Contractors Association
National Roofing Contractors Association
Painting and Decorating Contractors of America
Sheet Metal and Air Conditioning Contractors' National Association

Chairman ROSTENKOWSKI. Thank you very much, Mr. Weber.

Are there any questions of the panel?

Thank you very much for joining us this afternoon. We appreciate your appearance and we appreciate your observations. Thank you.

[Whereupon, at 2:25 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT
OF
AMERICAN BANKERS ASSOCIATION
ON
THE "DISCUSSION DRAFT" RELATING TO
ESTATE VALUATION FREEZES
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 8, 1990

The American Bankers Association is pleased to have the opportunity to express the views of bank trust departments concerning the Discussion Draft of a replacement for Internal Revenue Code Section 2036(c).

The American Bankers Association ("ABA") is the national, trade and professional association for the United States' commercial banks. Assets of ABA members are about 95% of the industry total. Approximately 3,500 bank trust departments provide fiduciary services for their customers.

The ABA is appreciative of the thought and effort that has gone into the preparation of the Discussion Draft. We feel that the process of issuing a Discussion Draft and holding hearings is a very helpful step down the road toward the repeal of Section 2036(c).

On March 22, 1990, Chairman Rostenkowski of the House Ways and Means Committee introduced a Discussion Draft of a replacement for IRC Sec. 2036(c), which would be repealed from the date of its original enactment, December 17, 1987. The replacement is by a new Chapter 14 captioned "Special Valuation Rules," which constitute essentially a gift tax valuation approach to the perceived transfer-tax "estate freeze" problem. These comments regarding the application of the Discussion Draft focus primarily on its application to trusts and buy-sell agreements and on transition rules, after brief comments on the classic estate freeze (with preferred and common stock) and partnership interests.

I. Classic Estate Freeze

Such a freeze results from a recapitalization, with the owner of a closely-held business who desires to transfer ownership to younger family members retaining preferred stock and gifting common stock to such members. The tax law should encourage (or at least not hinder) such transactions which seek to continue ownership in younger family members. IRC Sec. 2036(c) does not do this. Neither does the Discussion Draft, which requires the owner of the preferred stock to accept compounding of unpaid preferred dividends at an "appropriate" market discount rate to avoid a gift tax on such dividends. The Draft intentionally does not describe how this rate is to be determined.

When a decision is made on the discount rate, we doubt that it will be much below an arm's length rate. If this occurs and the Discussion Draft (with appropriate revisions) is substituted for IRC Sec. 2036(c), some other encouragement should be offered to closely held business owners. A simple way would be to reduce the interest rate on estate tax deferred under IRC Sec. 6166 to 80 percent of the normal rate. A 4 percent rate is now applicable to a part of the deferred tax but this part is subject to so low a ceiling that little relief is provided.

II. Partnership Interests

We have serious reservations regarding the operation of the Discussion Draft to partnership interests, which is not explained by the Summary or in the pamphlet (JCS-13-90) of the federal transfer tax consequences of estate freezes prepared by the staff of the Joint Committee on Taxation for the April 24, 1990 hearing.

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Our concern may be illustrated by using the facts of Estate of Daniel J. Harrison, 52 TCM 1306 (1987), discussed in the Joint Committee pamphlet. The decedent entered into a partnership with his two sons. Each of them was a general partner and prior to his death could withdraw his interest in the partnership. At death this right terminated and the deceased partner's interest was "locked in" the partnership for a fixed period of time. Would the execution of the partnership agreement be a transfer of a partnership interest by the decedent to his sons for purposes of section 2701(a)(1)? The answer is not clear. An inquiry to Staff produced a yes answer. The value of the decedent's retained interest (and also the sons' interests) is zero, unless (1) section 2701(a)(2)(C) applies (because each partner's interest is the same) or (2) the election in section 2701(b)(4) is available. The election is troublesome because of the requirement that the election state the amounts and times of the payments from the partnership.^{1/}

The important point is that a Harrison fact pattern should not be handled by a gift tax solution. Since each partner can withdraw his entire interest before death, what is involved is a revocable transfer, and it should be treated as such, which occurs with a trust pursuant to section 2701(a)(4)(A).

The easiest way to make Chapter 14 work with partnership interests, in general, would be to limit its scope to section 2702(b)(4)(B)(i).

III. TRUSTS

A. In General

Section 2701(a)(1) states:

IN GENERAL. - Solely for purposes of determining whether a transfer of an interest in a 10-percent owned entity to a member of the transferor's family is a gift (and the amount of such gift), the value of any interest in such entity retained by the transferor (or a member of the transferor's family other than the transferee) shall be determined as provided in paragraph (2).

Thus, Chapter 14 overrules Chapter 12 regarding transfers subject to this provision. Pursuant to section 2703(e)(1)(A)(iii), a trust is a 10 percent owned entity if 10 percent or more of the value of the beneficial interests in such trust is held by the transferor, and for this purpose the transferor is treated as holding any interest held by any member of his family. As a result, almost every inter vivos trust will be subject to section 2701(a)(1).

Under paragraph 2701(a)(2), the value of any retained interest in the transferor which is not a right to receive qualified fixed payments is zero. Pursuant to section 2701(b)(2), a qualified fixed payment (QFP) for a trust is defined as:

- (A) any fixed amount which is payable not less frequently than annually;
- (B) any amount which is payable not less frequently than annually and is a fixed percentage of the fair market value of the property in the trust (determined annually);
- (C) any payment described in paragraph (1)(A)(i) under a debt instrument or a lease; and
- (D) any amount payable under a noncontingent remainder interest if all of the other interests in the trust consist of interests described in subparagraph (A), (B) or (C).

^{1/} Quite apart from the Harrison example, this requirement will raise problems with virtually all partnership interests that do not qualify for the exception of section 2701(a)(2)(c)(i) or (iii).

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(A) and (B) refer to an annuity amount or unitrust amount similar to those found in the charitable lead and charitable remainder trusts areas.

Section 2701(a)(4) states that subsection (a) shall not apply to any transfer of a trust interest if:

- (A) such transfer would not constitute a gift if no consideration were received for such transfer, or
- (B) all of the property in such trust consists of a personal residence to be used by persons holding term interests (as defined in Section 2703(d)(3)) in such trust.

Under (B), a common law GRIT would continue to be permitted for a personal (not principal) residence. A term interest is defined as a life interest in property or an interest in property for a term of years. This definition is taken from IRC Sec. 1001(e)(2).

B. Important General Comments and Recommendations

The Discussion Draft would, in general, treat grantor retained interest trusts (GRITs) more severely than current law does with the Statutory GRIT exception in IRC Sec. 2036(c)(6). This is a questionable policy decision in the context of a replacement which is intended to lessen the impact of IRC Sec. 2036(c) and would be the third modification of the GRIT rules since June 1988. Even assuming the technical problems discussed below can be resolved, the further confusion and required learning process resulting from another change is, in our opinion, undesirable. On balance, we prefer a continuation of the two main restrictions on the grantor's retained interests in the Statutory GRIT concept in IRC Sec. 2036(c)(6), *viz.*, an income interest not to exceed 10 years in duration and a limited contingent principal interest.

If the approach of the Draft as to trusts is used, we have a significant problem with the "layout" of Chapter 14. Almost all trusts created by grantors are for the grantor or members of his or her family, with the result that section 2701(a)(1) is operative. Therefore, substantially all inter vivos trusts will have to be analyzed under Chapter 14. This is difficult under the Discussion Draft, in part because it merges trusts with partnerships and corporations and then proceeds to create many special rules for trusts. See sections 2701(a)(2)(B)(ii), 2701(a)(2)(C), 2701(a)(4), 2701(b)(2) and 2701(c)(4).

Considerable simplification would be achieved by separating the rules for trusts from those for partnerships and corporations. If this suggestion is accepted, the trust provisions should be made public for comment. We understand that with regard to trusts, only GRITs (and joint purchases) were intended to be covered by the Discussion Draft. If this is so, the trust provisions should be crafted to cover only such transfers and thereby avoid the problems presented by a broad statute with narrow exception. If separate trust treatment is rejected, ease of analysis as to trusts under the Discussion Draft would be greatly helped by the creation of another exception stating that if the entire trust is subject to gift tax, Chapter 14 will not apply. Other needed exceptions are discussed below.

The difficulty of the trust approach in the Discussion Draft may be illustrated by the language of section 2701(a)(1). Read literally, it seems to be referring to a transfer of a trust interest after the trust is created rather than to the creation of the trust itself. In this connection, see section 2703(e)(4), stating that in the case of a transfer of an income or remainder interest in a portion of a trust, Chapter 14 applies only to such portion. However, Staff has indicated section 2701(a)(1) is not intended to cover assignments of trust interests. Also, the word "retained" is inaccurate as to a trust and members of the transferor's family.

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C. GRATs and Charitable Lead and Remainder Trusts

The application of section 2701(a)(1) to a GRAT (grantor retained accumulation trust), which does not appear subject to IRC Sec. 2036(c), seems wrong. Under a GRAT, income is accumulated, with the trust property (and accumulated income) passing either to the grantor if he dies during a fixed term or to others if he survives the term. The application of the actuarial tables to this contingency - survivorship of the grantor for the fixed term - does not involve the imprecision of valuing an income interest.

Clarification is needed regarding the extent to which the split-interest rules of charitable lead and charitable remainder trusts are applicable. For example, is a commutation power permitted? See Rev. Rul. 88-27, 1988-1 C. B. 331, as to a commutation power in a charitable lead trust. Also, may the fixed amount be different in different years? Presumably, Revenue Rulings 76-273, 1976-2 C.B. 268, and 82-105, 1982-1 C.B. 133, would be applied in determining the includible portion of the trust when the grantor dies during the fixed term of his annuity interest or unitrust interest. Some issues arise in determining the includible amount which need to be resolved, as does the application of IRC Sec. 2642(f).

Charitable remainder trusts, as defined in IRC Sec. 664, should not be subject to Chapter 14, and a specific exclusion of them should be inserted in section 2701(a)(4). In this connection, a charitable remainder trust described in IRC Sec. 664(d)(3) would not involve qualified fixed payments as defined in section 2701(b)(2). Charitable lead trusts (where the entire charitable interest qualifies for the gift tax charitable deduction) should also be outside the scope of Chapter 14.

D. Technical Comments

1. In General

Section 2701(a)(1) and (2) create uncertainties and technical problems with certain trusts. The meaning of "transferee" in section 2701(a)(1), which is not defined, is unclear. To illustrate, if T creates a lifetime QTIP trust with income to his wife for life, remainder to his children, is the transferee the trust or the wife and children? The term "transferee" must be defined for trust transfers. Also, why is the value of any interest in the trust of a member of the transferor's family referred to when such an interest is subject to gift tax in any event?

Suppose T creates a discretionary trust for himself pursuant to which the trustee may pay him income or principal and upon his death the trust property is to be distributed to his surviving issue. Under current law, the creation of the trust would not be a gift if creditors of T can reach the trust property, as would be the case with the law of most states. Under the general rule of section 2701(a)(1) and (2), the entire value of the trust would be a gift because the grantor has not retained a right to receive qualified fixed payments. However, as noted, section 2701(a)(4)(A) creates an exception for a transfer which "would not constitute a gift if no consideration were received for such transfer." This provision is ambiguous because the word "gift" could refer to the meaning in section 2701(a)(1) or the meaning under Chapter 12 and a different result is produced with each meaning. In section 2703(a)(2), reference is made to a "gift for purposes of chapter 12." The intent seems to be to refer to the Chapter 12 meaning in section 2701(a)(4)(A), and the provision should be changed to so state. In addition, the double negative should be eliminated by referring to consideration in a separate sentence, such as:

For purposes of [the preceding sentence] any consideration received by the transferor should be ignored.

Suppose T creates a trust with the income payable to himself for life, remainder to charity. Under section 2701(a)(1), the full value of the trust property will be a gift, although under present chapter 12 only the value of the remainder interest is subject to gift tax. The same result would follow if the remainder were at T's death given to the surviving issue of T.

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Neither of these cases, where the entire trust property will be included in T's gross estate, should be subject to section 2701(a)(1).

Suppose T creates a trust with income payable to his children for a fixed period of time and with the trust property then to be returned to him or, if he is not then alive, to his estate. Under section 2701(a)(1), T would make a gift of the full value of the trust property.^{2/} Section 2701(b)(2)(D), applicable to a noncontingent remainder interest, does not apply because all other trust interests are not described in paragraph (A), (B) or (C). If, however, T has retained a lesser interest - a right to receive an annuity amount or a unitrust amount - its value appears to be deducted in computing the amount of the gift. This is the case even though it is a future interest and in back of a "tainted" interest, and even if it is conditioned upon survivorship. An additional exception should be added to section 2701(a)(4) to cover a transfer if the trust property must either be included in T's gross estate or distributed to him during life.

Section 2701(a)(2)(C) states:

Valuation of Certain Other Rights -- The value of the following retained interests shall be determined without regard to this section:

- (i) Any instrument of the same class as the transferred interest.
- (ii) Voting rights.
- (iii) Any instrument none of the rights under which have a preference over any rights under the transferred interest.

This subparagraph shall not apply in the case of a trust.

The effect of excluding a trust, which is not explained in the summary of the Discussion Draft, is uncertain and should be clarified. The exclusion could be read to prohibit minority discounts for stock placed in a trust. A trust should not be treated differently than an individual in this regard.

Suppose a trust directs that income be paid to A for life and at A's death the trust principal is to be distributed to A's surviving issue. A has one child B and no other children. B makes a gift of his contingent remainder interest to his two children. This appears to result in a gift equal to the full value of the trust property because the value of A's income interest is determined under section 2701(a)(2) and is zero. The result is wrong when the gift is the entire interest owned, or a fractional share thereof.

As previously noted, a term interest is defined as a life interest in property or an interest in property for a term of years, which are words used in IRC Sec. 1001(e). Treas. Reg. #1.001-1(f)(2) states in part:

Term interest defined. For purposes of section 1001(e) and this paragraph, a "term interest in property" means -

- (i) A life interest in property,
- (ii) An interest in property for a term of years, or
- (iii) An income interest in a trust

Generally, subdivisions (i), (ii) and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event

^{2/} The same result would occur if the income beneficiary was not a member of T's family because of Section 2703(a)(4).

or contingency to occur. Such divisions do not refer to remainder reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest.

The regulation does not answer the question whether an interest for the shorter of life or a term of years is a term interest. This important issue should be resolved by statute rather than by regulation.

The reason why the personal residence exception in section 2701(a)(4)(B) applies only when the residence is the sole asset of the trust is unclear. Since any other asset transferred to the trust will be subject to Chapter 14, what is the problem with other assets? Also, if the other assets were transferred to the trust after the residence was transferred, such assets would be valued for gift tax purposes under Chapter 14.

2. Failure to Pay Annuity or Unitrust Amount as Gift

Pursuant to section 2701(c), if payment of the entire annuity or unitrust amount from a trust for a calendar year is not made within 65 days of the close of that year, the grantor is deemed to have made a gift on the last day of the year equal to the underpayment. This result is incorrect when a unitrust amount payable to the grantor is involved because the grantor retains a unitrust interest in the amount of the gift. An incorrect result is also produced under section 2701(c) when a preferred shareholder is also a common shareholder. He should not be deemed to have made a gift to the extent that the value of his common shares are increased by the failure to pay the preferred dividend. Similarly, if a charity is a common shareholder a gift tax charitable deduction should be allowed as to its share of the gift.

If the underpayment is later satisfied, any gift tax paid by the grantor is treated as a payment for the later year and the amount of the underpayment is excluded from taxable gifts for the purpose of determining the grantor's gift or estate tax. Treating the gift tax paid as a payment for the later year should not cause the application of IRC Sec. 2035(c) as a result of such treatment. However, clarification on the point would be helpful.

3. Gift or Estate Tax Treatment of Other Retained Interests

Section 2701(e) is captioned "Adjustment in Value of Other Specially Valued Retained Rights" and relates to a right under a specially valued retained interest, which is defined in section 2703(e)(2) as any retained interest valued under section 2701(a)(2)(A) or (B). This would include any contingent principal interest in a GRIT whose value is determined to be zero pursuant to (A). Section 2701(e)(1) directs that as to any specially valued retained interest, other than a QFP, for purposes of determining (i) whether any transfer of such right is a gift (and the amount of such gift) or (ii) the amount includible in the gross estate of the transferor "by reason of such right" the amount otherwise treated as the value of such right shall be reduced by the amount of the increase in any prior taxable gift as a result in valuing such right at zero. As a result, the later transfer by gift or inclusion in the gross estate is reduced.^{3/}

If the grantor of a GRIT with a contingent principal interest assigns this interest, section 2701(e)(1) prevents a further gift being made, but this does not cause a reduction in the gift previously made when the GRIT was created. Thus, no tax benefit can result from the assignment. The reduction of the amount includible in the gross estate when the grantor dies during the term of his retained interests may prevent a change in basis pursuant to IRC Sec. 1014, which may be harmful or helpful. The result turns upon the effect of the words "by reason of such right." Inclusion would also result because of the retention of the annuity amount or unitrust amount, and this would

^{3/} The Section needs to be revised to encompass Chapter 13 transfers.

seem to negate the effect of section 2701(e)(1). This ambiguity should be eliminated. Also, the effect of the reduction of the gross estate is unnecessary because the same result occurs under IRC Sec. 2001(b); the gift resulting from the disallowance of a reduction for the value of the contingent principal interest is not an "adjusted taxable gift."

4. Joint Purchases and Consideration

Under section 2703(d)(1), the transfer of an interest in property with respect to which there is one or more term interests is treated as a transfer of an interest in a trust. A "term interest" is defined in section 2703(d)(3) as a life interest in property or an interest in property for a term of years. Section 2703(d)(2), captioned "Joint Purchases," provides that if members of the same family acquire interests in property in which one or more term interests exist the person (or persons) acquiring the term interest shall be treated as having acquired the entire property and then transferred to the other persons the "interests acquired" by them. The meaning of the quoted words is uncertain. What is meant is that for purposes of section 2701(a)(1) the person with the term interest is deemed to have created a trust with the entire property.

Under the proposed statute, if A and B purchased property for 100, with A supplying 75 and having a life interest and B supplying 25 and being entitled to the property at A's death, A is deemed to have made a gift of 100 since A's interest is not an annuity amount or a unitrust amount.

Presumably B's 25 is an offset against the gift to reduce it to 75, but this point is not clear because Chapter 14 does not refer to consideration except in section 2701(a)(4)(A) which has previously been discussed. Section 2703(d)(2) does not apply to B. Under section 2701(a)(1), B seems to make a gift of 25. This result is, of course, wrong and points up again the necessity of a consideration provision in Chapter 14, as is acknowledged by the Joint Committee pamphlet (JCS-13-90).

IV. BUY-SELL AGREEMENTS; OPTIONS; SECTION 2702

A. In General; Policy Issues

Section 2702(a) would create the general rule that for gift, estate and generation-skipping transfer tax purposes the value of any property would be determined without regard to any of the following rights held by a member of the family of the transferor or decedent:

- (1) Any option (or agreement) to acquire the property at a price less than the fair market value of such property (determined without regard to the option or agreement) as of the time the option (or rights under the agreement) are exercised.
- (2) Any right of first refusal (or similar right) with respect to such property.
- (3) Any right to use such property pursuant to a lease.

Subsection (b) creates an exception to the general rule if:

- (1) the property is sold pursuant to such option or agreement,
- (2) the price at which such property is so sold is determined pursuant to a formula which -
 - (A) was reviewed no more than 3 years before such sale, and
 - (B) at the time of such review, was reasonably expected to produce a price which would approximate the fair market value of such property as of the time of such sale, and
- (3) such property does not have a readily ascertainable market value

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and such property is not resold before the date 6 months after the date of the death of the decedent (or the transfer in the case of a transfer subject to tax under chapter 12 or 13) to a person not related (within the meaning of section 267) to the decedent or transferor (as the case may be).

Leaving aside the technical problems with the exception discussed below, its formulation presents a serious practical problem. Aggressive IRS estate tax agents will simply take the position in audits that the formula price was not reasonably expected to produce an approximately fair market value price. The only way for the exception to work in a uniform manner would be for the IRS National Office to describe formulas which would meet the test.

The application of section 2702 is unclear when the shareholders' agreement requires a sale to the company (redemption) and some of the other shareholders are members of the decedent's family and other shareholders are not members of his family. Section 2703(c) provides that a redemption is treated as a transfer of an interest in the corporation. The effect of sections 2702(a) and 2703(c) appear to be that for shareholders who are members of a decedent's family the agreement is ignored for estate tax purposes but for shareholders who are not members of the decedent's family the agreement price may be binding for estate tax purposes. Such a bifurcated approach is undesirable.

Also, a related provision (section 2703(a)(2)) states that if any transfer of property would be treated as a gift for gift tax purposes without regard to Chapter 14, the transferee shall be treated as if such transferee were a member of the transferor's family. As a result, if the execution of a shareholders' agreement among siblings (who under section 2703(a)(1) are not members of each other's family) involves a gift, section 2702(a) would apply. This is a bad policy decision. The law regarding whether entering into a buy-sell agreement constitutes a gift from one or more shareholders to other shareholders is uncertain. However, the IRS position is clearly that a gift can result. The IRS Action on Decision CC1985-008 dealing with Estate of Orville B. Littick, 31 T.C. 181 (1958), acq. 1959-2 Cum. Bull. 5, and recommending acquiescence in result only, states:

Substantial disparity in the life expectancies of the contracting parties means that the promise of the party likely to predecease was worth more than the promises of the other parties. Therefore, the execution of the crosspurchase agreement gave rise to an immediate transfer of a contract right for less than adequate consideration. Since this was an intra-family agreement, the transaction should be closely scrutinized to determine whether it was executed as a gift or in the ordinary course of business under Treas. Reg. #25.2512-8. In our view, the court improperly ignored the great weight of the evidence when it found that the instant agreement was negotiated at arm's length with no tax avoidance motive. However, inasmuch as the court's determination was a factual one with some support in the record, the decision was not clearly erroneous.

We disagree with the policy decision in section 2703(a) to ignore a right of first refusal for gift, estate and Chapter 13 valuation purposes. Such a right is commonly used, even among shareholders who are members of the same family, and does depress somewhat the value of the affected interest. However, the IRS is free to contend under current law that the creation of such a right is a gift. If concern exists on this point, the Discussion Draft could so state. An "early to complete" gift tax rule is desirable for a right of first refusal. If this is not done, a potential marital deduction disallowance issue could be created at a shareholder's death for the difference between the value of the stock determined with and without the first refusal right.

B. Technical Comments

1. Options

The application of sections 2701 and 2702 concerning options is uncertain. Suppose T grants his daughter D an option exercisable within ten years to purchase 100 shares of AT&T stock at its fair market value when the option is granted. Under Chapter 12, this would be a gift. Section 2702(a) directs that the value of T's stock for gift, estate and Chapter 13 tax purposes is determined without regard to the option, if it is at a price less than the fair market value at the time the option is exercised. When the option is granted, it is uncertain whether this test is met. Nevertheless, the intent seems to be for the section to apply and, if it does, the stock has the same value before and after the grant of the option. Therefore, T has made no transfer with any value for gift tax purposes. In any case, the initial gift would be no larger than under the law without the section.

If T dies with the option in effect, the estate tax value of the stock will be determined without regard to the option, as would be the case if T gave the stock to a third party subject to D's option. However, if D exercised the option while T is alive, after the stock has appreciated, section 2702 does not apply because it only determines value. The exercise of the option will not be a gift under Chapter 12.

Does Section 2701 apply to the grant of the option? Stated another way, does the section make the gift upon grant of the option any greater than it would be without the section? In contrast to section 2702, section 2701 applies only if the stock is in a "10% owned entity," which is defined in section 2703(e)(1). This would occur only if the shares subject to the option are treated as a "trust." Section 2703(d) states that certain property is treated as held in trust, and the words "term interest" can be read to cover an option. Of course, if the shares subject to the option are in a corporation and 10 percent or more of the value of its stock is owned by T, section 2701 would apply.

Are the exceptions in section 2701(a)(2)(C) applicable? They are:

- (i) Any instrument of the same class as the transferred interest.
- (ii) Voting rights.
- (iii) Any instrument none of the rights under which have a preference over any rights under the transferred interest.

Arguably (i) or (iii) could apply, but the language does not "fit" well with the case being considered.

If section 2701(a) does apply, the stock seems to have a zero value, and the grant of the option is a gift of the full value of the stock.

2. Special Rule

Read literally, the section 2702(b) exception would not apply when no review occurs within the 3 year period even though if the review had taken place the formula in effect would have satisfied the other requirements of this exception. This result is wrong.

The use of the word "reviewed" suggests that the "formula" used is continued. A new formula could be used. The word "established" would be preferable. Also, when the sale occurs as a result of death, the 3 year period should be measured by death rather than the actual sale date. The use of the words "readily ascertainable market value" is imprecise. As to stock, a reference to traded on a securities exchange or in the over-the-counter market would be preferable. See IRC Sec. 6166(b)(7)(B). It is unclear whether the reference to the quoted words is made as of the date of sale or at some earlier date. The reference should be to the time of the establishment of the protected formula.

3. Other

We are puzzled by (3) in section 2702(a). Suppose a parent is leasing a residence owned by a child at a rent above the "going rate." The child can then transfer the residence to his child (a grandchild of the parent) without having the amount of the gift reflect the high rent. Why?

An exception needs to be created for cases where the formula establishment process cannot be effectuated because of the incompetency of a major shareholder or shareholders.

The definition of "family" in section 2703(a)(1) seems faulty. To illustrate, assume a shareholders' agreement exists and requires a sale to the company, except that a transfer to a QTIP trust is permitted, and a shareholder has children by a prior marriage and a second spouse and leaves shares to a QTIP trust for his spouse. At the death of the surviving spouse a sale to the company occurs when the other shareholders are children of the spouse who created the QTIP. Such children are not members of the surviving spouse's family.

V. TRANSITION RULES

A. Trusts

The Discussion Draft does not address transition issues, but rather states "The amendments made by this section shall apply in the case of transfers after ____." These issues will, of course, have to be dealt with. An important issue is whether Statutory GRITs which are created after March 22 and before a tax writing committee approves a change in current law will be "protected." Fairness requires a yes answer, but obvious concern exists on the point. In this connection, a grantor cannot now create a GRIT using a retained annuity or unitrust amount because neither one can satisfy the Statutory GRIT requirements as a result of the limitation on principal interests.

We recognize that an effective date in the future and a retroactive repeal of IRC Sec. 2036(c) would create a window of opportunity for trusts to be established before that date which would be subject to neither the new law nor the old law. The window could, of course, be closed by retaining the provisions of IRC Sec. 2036(c)(6), but this would have the undesirable effect of perpetuating and having to interpret a provision for a small number of cases. The indirect administrative cost of doing so would appear to be more than the possible gain in tax revenues.

B. "Old" Freezes

Current law provides that for purposes of the effective date of IRC Sec. 2036(c) with respect to property transferred prior to December 18, 1987, the failure to exercise a right of conversion, or the failure to pay dividends or the failure to exercise other rights specified in regulations, will not be treated as a transfer under IRC Sec. 2036(c). The Discussion Draft does not contain such a provision. As a result, for example, the failure to pay the full amount of a noncumulative dividend on preferred stock, could result in a gift under the Draft if, as seems likely, that failure is considered to be a "transfer of an interest" in the issuing corporation. This is unfair. The policy consideration which led to the exclusion from IRC Sec. 2036(c) also applies to the application of the Draft. The failure to have the gift determined under the Draft does not mean no gift has been made, but only that the applicable statute is in Chapter 12 rather than Chapter 14.

C. "Old" Buy-Sell Agreements

Section 2702 is harsher than current law because it applies to agreements now in effect which are not thereafter changed. Existing agreements should be governed by current law absent an amendment which reduces the purchase price.



AMERICAN FARM BUREAU FEDERATION

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May 1, 1990

The Honorable Dan Rostenkowski, Chairman
House Ways and Means Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Representative Rostenkowski:

This letter is in reference to the committee's hearing on April 24, 1990, dealing with estate freezes. We ask that our comments be included in the hearing record.

Farm Bureau represents over 3.8 million member families. The vast majority of them are farmers and ranchers who plan one day to turn their business operations over to their sons and daughters to continue the family business. Farm Bureau members have long recognized that estate taxes can be a major stumbling block in continuing the family business. It has been all too common that farmers and ranchers have had to sell part of the estate to pay the taxes. This has meant the dissolution of the business and has prompted Farm Bureau to maintain a policy of opposing the estate tax.

To minimize the effect of estate taxes, many farmers have used estate planning including estate freezes to pass the farm to the next generation. As you have heard in recent months, Section 2036(c) and the vagueness of the provision have severely limited the ability to use estate freezes as a way to minimize estate taxes. It is our understanding that no widescale abuse of estate freezes occurred in agriculture or small business. We believe that Section 2036(c) is unjustified.

Farm Bureau urges the committee to repeal Section 2036(c). While its benefits to the government are questionable, the havoc it plays with the orderly transfer of family business from one generation to the next is undeniable.

Thank you for your consideration of our views.

Sincerely,

John C. Datt
Executive Director
Washington Office

JCD/lh

**ASSOCIATED BUILDERS AND CONTRACTORS
TESTIMONY ON THE "DISCUSSION DRAFT" TO REPLACE SECTION 2036(c)
RELATING TO ESTATE VALUATION FREEZES**

Associated Builders & Contractors appreciates this opportunity to present its views on the current estate valuation rules under Section 2036(c) and the replacement "discussion draft" under consideration. ABC represents over 18,000 contractors, subcontractors and suppliers who are united by the Merit Shop philosophy of management. Our membership, like the construction industry as a whole, is dominated by small, family-owned firms. Over 80 percent of our members do less than \$10 million in construction volume per year.

We would first like to commend Chairman Rostenkowski and the Department of Treasury for giving the business community the opportunity to participate in the formulation of this important and highly complex issue. The product of this kind of cooperation and public debate could serve as a model for other legislation and no doubt lead to better tax law in the future.

Mr. Chairman, the continued growth and prosperity of family-owned business require that Section 2036(c) be repealed. This provision of the tax code jeopardizes the ability of contractors to pass their businesses on to their children -- something our members believe is a fundamental right and essential to the economic strength of the nation. Indeed, estate planning professionals testified last year before the Senate Banking Committee that section 2036(c) should be repealed and any substitute legislation should be delayed until Congress can examine the entire transfer tax system and its effect on small business. Construction contractors' businesses clearly cannot survive when up to 60 percent of the value of their firms are lost to taxes each time a generational transfer is made.

Efforts to repeal section 2036(c) have progressed in a truly bipartisan fashion. Congressman Archer's bill to repeal this rule has 218 cosponsors, and several bills have been introduced in the Senate which also repeal section 2036(c). In fact, the Senate Finance Committee approved repeal during its consideration of the budget reconciliation bill last year.

Section 2036(c) was added to the Tax Code in 1987 to stop perceived abuses in estate planning techniques. Despite its intentions, its impact was far greater than that. This provision prohibited common transactions for transferring company assets, favored those families whose personal assets were in securities investments rather than business ownership, discouraged the participation of the children in the business, and drastically raised the costs of transferring ownership. So much so that contractors' businesses would have to be sold or liquidated by their children to pay the estate taxes upon his death. If ever there was a provision in the tax code to limit the financial life of a successful firm and discourage small business growth, its section 2036(c).

THE DISCUSSION DRAFT

Any replacement for section 2036(c) must guarantee that successful closely-held businesses can continue to flourish from generation to generation. It should also ensure that estate and financial business planning can proceed with unambiguous and consistent rules and guidelines.

The discussion draft makes some major strides toward that goal. It recognizes the legitimacy of "freeze" transactions and does not transfer the appreciation of the founder's surrendered interest into his taxable estate. It also addresses the perceived valuation problem which gave rise to section 2036(c) by approaching valuations properly as gift taxes rather than estate taxes.

Although there are elements of the draft that are acceptable, there are many flaws as well. To start, the proposal is too broad in scope and consequently overly complex. Its restrictive valuation process would be very difficult to administer and thus make ordinary business transactions too costly for family-owned firms.

Specific concerns are outlined below:

- o The proposal should not apply to buy-sell agreements. These agreements, leases, debt and other business arrangements should not be the single criteria for a valuation system. Buy-sell agreements are used by most closely held businesses. The true value of property would be determined without considering any option or agreement when the rights are exercised unless the price formula for determining value is reviewed.

This provision applies to all buy-sell agreements of greater than three years duration regardless of whether they are connected to estate valuations or not. It would be especially burdensome in the construction industry where equipment and other capital expenditures would be subject to review every three years by the IRS. ABC is concerned that the valuation formulas imposed in this provision would not accurately reflect the market value of the contractor's assets.

Most of our members would not have the time or inclination to engage in the kind of sophisticated estate planning that would be necessary to comply with this rule. The costs of complying with this administrative burden is unnecessary and fails to take into account how small businesses operate.

- o Restrictions are too severe on the ability to withhold dividend payments to the founder, known as Qualified Fixed

Payments (QFPs). The exceptions do not adequately reflect economic, financial or other legitimate business reasons for delaying such payments.

ABC believes that such exceptions must be allowed in cases where a construction contractor's surety bonding capacity is threatened. The payment of QFPs in cases where equity levels would be severely diminished below bonding requirements means these contractors would be unable to compete for projects they would normally bid on. This downsizing of the firm would be self-fulfilling prophecy. The assigned dividend rate becomes tougher to meet as the firm's revenues fall. The firm's revenues fall because its bonding capacity is reduced. The contractor's bonding capacity is reduced because the QFP requirements are eating up retained equity. Expansion becomes much more difficult, if not impossible as the contractor cannot meet his financial obligations. Once this scenario is put in motion, the contractor's recourse is to declare bankruptcy or insolvency -- one of the acceptable exceptions!

- o A related concern is the requirement that the valuation of founder's retained interest be based almost exclusively on the market rate of the fixed cash distributions. It is likely the founder's preferred stock dividends must be set as high as the company's debt. To set it any lower would result in a gift tax penalty because the exchange was not equal.

According to the American Institute of Certified Public Accountants, since dividends are nondeductible, the family-owned corporation must earn approximately 50 percent more, before taxes, to meet its dividend obligations. Such a steep commitment will result once again in contractors being unable to generate sufficient revenues to cover their expenses.

o The proposal lacks guidance in defining an acceptable "market rate" for the founder's QFP when compared to an arbitrary benchmark rate. The proposal's benchmark rate by itself is inequitable because it fails to consider external and other business factors that influence a contractor's ability to pay an identical QFP rate. If the QFP is lower, the gift tax will be high, regardless of the firm's liquidity or its ability to approximate the benchmark rate.

Contractors are dependent on a variety of factors beyond their control that affect their cash flow and thus their ability to pay a specified QFP rate. Construction projects can get delayed by weather and unforeseen soil and geologic conditions at the work site. Disputes over performance and payment often develop, which can delay revenues for years. There are a myriad of circumstances in the construction industry which can impact a firm's payment rate. Not the least of which are the size of the firm and its location. Construction in one region of the country may be stagnant while another is booming.

Moreover, typically the industry has low earnings to assets ratios, which requires QFP rates to be set low for contractors to survive. If this provision survives Congressional scrutiny, it is critical that benchmark rates be flexible and that they be segmented by geographic region and industry classification.

o The stipulation that the value of the junior equity interest equal at least 20 percent of the company's equity plus debt is unnecessary. Valuation principles for preferred stock already examine the asset coverage ratio and the dividend coverage ratio of the preferred stock. Assigning such a percentage is arbitrary, too high a proportion and will require the parent to pay enormous gift tax penalties if future recapitalizations are required. Also, including debt as equity will impair the ability of firms to secure bank debt but who are currently relying on shareholders for equity financing.

ABC recommends that there be no arbitrary floor value. Catching abusive recapitalizations is a laudatory public policy goal, but eliminating them is not the goal of this draft proposal.

Mr. Chairman, we again thank you and the committee for encouraging the healthy dialogue that has framed the debate on section 2036(c). ABC believes that a workable, simple solution to abusive estate freezes and valuation problems can be crafted. The replacement draft is a constructive first step in that process. It is essential, though, that we undertake this effort without delay. Small businesses everywhere are left vulnerable until such legislation is passed.

ABC appreciates the opportunity to submit this testimony and looks forward to working with the committee on this issue.

The Seattle Times

F. A. BLETHEN
PUBLISHER AND CHIEF EXECUTIVE OFFICER

April 20, 1990

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

The Seattle Times Company and Blethen Corporation would like to take this opportunity to express our views relating to the hearing to be held on a "discussion draft" to modify section 2036(c) of the Internal Revenue Code relating to estate valuation freezes on Tuesday, April 24, 1990.

The "discussion draft" is an improvement over 2036(c). Unfortunately, it isn't much of an improvement. Section 2036(c) is extremely bad legislation with very negative public policy implications. Much more needs to be done to correct the problems it created.

The primary problem with 2036(c) is that it represents an overly complex shotgun approach to try to cure a limited abuse which requires a rifle shot approach. While the "discussion draft" provides slight improvement, it is still overly broad, overly complex. It remains a shotgun approach to a rifle shot problem. The result is that the replacement legislation would continue to be anti-small and anti-private business and poor public policy for our local communities.

What we need is replacement legislation which very narrowly addresses the limited legitimate abuses which have occurred.

The very nature of 2036(c) and potential replacement language is one which penalizes private and family businesses and which has a strong anti-business tone.

Replacement language should recognize that small and private businesses are extremely valuable resources to our overall economy and to our individual local communities. It should recognize that preserving and passing on these community assets is extremely difficult given family and shareholder dynamics, normal business risk and government regulation.

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The existing difficulties associated with preserving small business entities too often results in the loss of these businesses. Many end up becoming part of a national or regional chain or conglomerate. The resulting absentee ownerships usually run the business for short-term profits with little regard for the long-term interests of the community or workers.

While this is an extremely important issue in our corporation, it is also a very important public policy issue. The national economy and our local communities would benefit immensely from a public policy that nurtured and encouraged the survival of private, small business with local ownership.

Discussion

There is no question the public would be better served if section 2036(c) were repealed retroactively to its date of enactment. It is, and continues to be, poor public policy and an anti-family business statute.

In addition to unduly restricting planning by family business owners, it is so complex and so overreaching that even with some clarification issued late last year, neither taxpayers nor the Internal Revenue Service really understand how it should be applied.

The basic approach the "discussion draft" takes is not to include property in a person's estate, as did section 2036(c), but rather try to fairly value an interest in a closely held business, or other entity, at the time of its transfer.

This (transfer) is the right time to deal with the problem, rather than waiting until someone dies. In that respect the draft is an improvement over section 2036(c). However, it appears to have many of the unfortunate characteristics of section 2036(c); it too is complex and overly broad in its application.

We understand the basic problem at which section 2036(c) was directed involved "abusive" situations where a taxpayer (often the owner of a family business) would transfer common stock from a company, and retain preferred stock which supposedly would pay a high dividend, but then no dividends were ever declared. However, in valuing the common stock the full value of the retained preferred stock that was kept was taken into account. The same thing apparently happened in a partnership setting. Section 2036(c) went far beyond that abuse, however.

We had hoped the "discussion draft" was limited to dealing with the particular undervaluation problem. Unfortunately, it goes so far beyond and it is subject to a lot of the same criticisms leveled at section 2036(c) -- its complexity, its overly broad application and its unrealistic assumptions regarding family businesses.

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The basic thrust of the "discussion draft" is to permit the value of retained preferred stock to be deducted from the value of the company, in a situation where common stock of the company is given away, only where there are dividends fixed both in time and amount. If the payments don't qualify as such, then they are given a zero value. Even if the stock qualifies in terms of having that kind of a payment, if no payment is actually made for three years, then there is a deemed gift of the amount that should have been paid. In addition, we understand that taxpayers can elect in or out of that treatment.

If this is as far as the statute went, it would be an improvement over section 2036(c), although we are troubled by an inflexible rule that gives zero value to something that clearly has value just because it doesn't contain a number of provisions that the government thinks it should. However, we are told the new proposal goes much further than that in terms of dealing not only with such things as preferred and common stock, but also prevents the deduction of the value of a lease or a debt from a company's value whose stock is transferred if the lease or debt is not properly structured in terms of providing for fixed payments. We also understand the statute covers all sorts of trusts although that is of less real interest to us than the business aspect.

An example of why it is inappropriate for the statute to cover leases. Often a family will own real estate and a family business. The real estate is quite often leased to the business to provide an income flow to the family. Often the rent is dependent (realistically) on the amount of profits the company makes. That kind of a lease is not at all unusual with outside parties, either. Yet that kind of a lease, as I understand it, would be assigned no value at all (in terms of the value retained by the transferor of stock in a company) in valuing the stock. Likewise, if a corporation owes me money and the debt does not meet the standards of the statute, then I can't deduct it from the value of the company, either.

The "discussion draft" also deals extensively with buy-sell agreements. These agreements are common in family-owned businesses. One of the chief criticisms of section 2036(c) was that it unduly restricted the utility of such agreements which usually are not used to try and reduce one's estate taxes. They are also dealt with, even more extensively, in the "discussion draft." The provision basically says that the value set by a buy-sell agreement for shares in a family company, for example, won't be respected by the Internal Revenue Service unless there is an actual sale of the stock, and unless it meets other requirements which are unrealistic. The "discussion draft" makes it clear that rights of first refusal will be given no value at all with respect to affecting the value of the stock, even though everyone knows they do affect value. Just as these provisions dealing with buy-sell

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agreements did not belong in section 2036(c), they certainly don't belong in a statute which was supposedly only aimed at dealing with abuses involved in recapitalizations where unrealistically optimistic assumptions were made with regard to valuing the preferred stock.

The statute is also intrusive and overly complex because it affects any company in which a person owns 10% or more and because all sorts of people other than the owner of the stock are involved in the statute's application. First of all, if one only owned 10% of a business, there certainly isn't enough ownership to make it "my" corporation as opposed to a public company. Furthermore, for purposes of computing the 10%, all sorts of family members are taken into consideration. As a businessman knows, you don't have real control of a corporation unless you have at least 50% of the stock and, in many cases, two-thirds of the stock. One also can't rely on other members of a family to always vote together.

There is also a provision that "equity" interest in such an entity must be at least 20% of the total value. In many instances involving closely held businesses the ratio is, for legitimate economic reasons, much lower than that, yet there is an arbitrary provision that if debt represents 81% and equity represents 19%, that the value of any preferred stock interest will be zero for purposes of determining the value of common stock which has been given away. Surely this is arbitrary and unfair and particularly so because it only applies to family businesses.

We understand that if a dividend is provided for but is not paid after three years, then unless the company goes insolvent or bankrupt, one will be deemed to have made a gift of that dividend to the holders of the common stock, even though one may well not have control of the company. One can think of a number of instances where short of insolvency or bankruptcy it simply would not be prudent for a company to pay dividends, yet such dividends are in effect forced out in order to avoid a gift tax. Surely this is not the kind of abusive situation which Congress must have had in mind when first enacting section 2036(c).

Summary

There is serious question whether a statute is needed at all. However, if there is one, we would like to see a statute that deals directly with the really abusive situations which doesn't burn honest taxpayers and owners of closely held businesses in trying to carry out legitimate family succession planning. Section 2036(c), and also the "discussion draft," is the kind of legislation that really erodes the self-assessment tax system which has been a hallmark of our country for many years. Gift and estate tax rates are so high that a closely held business owner, if his business somehow becomes subject to this new statute (e.g., in terms of having to pay a dividend to prevent mount-

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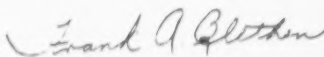
ing delinquent gifts) might be forced to sell his business to an outsider. These days, such an outsider means not just someone outside the family but often someone outside the country. Surely Congress cannot have meant to encourage foreign ownership of such U. S. business enterprises. I can guarantee you that there will be a lot less tax collected. It is also counterproductive to job formation and quality local involvement for local, private companies to be forced to sell to out of state conglomerations who operate for short-term financial gain rather than long-term community interest.

Conclusion

We hope section 2036(c) is repealed promptly and that before any substitute is made that that substitute is well thought out, limited in scope, and responsive only to whatever perceived abuse there is. Enacting the provisions of the "discussion draft" will put us all in the same boat that we have been in for the last two years under section 2036(c). Surely, that is going backwards.

The Seattle Times Company and Blethen Corporation appreciate this opportunity to submit our views with respect to a "discussion draft" to modify section 2036(c). Please contact Malcolm Moore, Davis Wright Tremaine, (206-622-3150), or myself (206-464-2957), if you have any questions or need further information.

Sincerely,



Frank A. Blethen

STATEMENT
OF
WILLIAM J. BROWN
Professor of Law
University of Pittsburgh

Introduction

Section 2036 was originally enacted nearly 60 years ago in reaction to the Supreme Court's opinion in *May v. Heiner*.¹ Immediately after that decision Congress perceived the necessity for a provision to estate tax property conveyed *inter vivos* whenever the circumstances or terms of transfer enabled the transferor either to enjoy income from the property or to affect its enjoyment by others. The value of previously conveyed property, at its date of death value, was rendered includible in the transferor-decedent's gross estate by § 2036, and rightly so. Whenever a lifetime transferor continues to control or benefit from property that he has conveyed, its prior transfer ought be disregarded for Federal estate tax purposes.

Eighteen years ago, another Supreme Court decision² provoked a remedial amendment to § 2036 so that retained voting rights in corporate stock transferred *inter vivos* would be regarded as an estate-taxable string. Section 2036(b) treats the retention of voting rights in transferred shares as a means of continuing one's enjoyment of the transferred property — which results in estate taxability of the property's value whenever the transferor dies. Unfortunately, § 2036(b) did not reach those transferors who maintained control over their business by retaining preferred stock voting rights while giving away common stock.³ Valuation of the preferred shares includible in the transferor's estate would be based on its dividend rate and fixed dollar preference in liquidation, whereas the common shares that had negligible value at the time of gift would appreciate⁴ as the business thrived but completely escape estate taxability. As this evolution of § 2036 indicates, property owners have repeatedly sought to fashion transfers that become completely effective only at their death. Whenever *inter vivos* transferors receive benefits for themselves without incurring estate taxability of the value ultimately inuring to their transferees, an obvious abuse results — which requires corrective legislation.

Inventive estate planners most recently have contrived *inter vivos* conveyances that entail relatively little or no gift taxability but which leave the transferor with cash flow benefits from the conveyance. Because these economic vestiges of ownership were not estate taxed at the transferor's death, § 2036 was again threatened with erosion. Section 2036(c) is aimed at interdicting these latest maneuvers, which are sometimes referred to as "valuation freezes" because their objective is to avoid transfer

¹281 U.S. 238 (1930).

²*United States v. Byrum*, 408 U.S. 125 (1972). The *Byrum* case sounded the death knell for Revenue Ruling 67-54, 1967-1 C.B. 269, in which a transferor's ownership of 10 shares of voting stock in a corporation that also had 990 shares of nonvoting common stock outstanding (which were transferred *inter vivos* into a trust for the owner's children), constituted a § 2036(a)(2) retention of control over the transferred shares.

³See Revenue Ruling 81-15, 1981-1 C.B. 457.

⁴*Estate of Salisbury*, 34 TCM 1449, CCH Dec. 33,503(M), TC Memo. 1975-333 (1975).

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taxes on the post-transfer appreciation in worth of property conveyed *inter vivos*. This provision's complexity can be attributed directly to the variety, intricacy, and ingeniousness of those popular valuation freeze techniques. Inasmuch as the existing provision has been interpreted of late by regulations, however, any confusion about the meaning of its terms "enterprise" and "disproportionately large share" should now be resolved.

By standing ready to estate tax those who would retain ownership vestiges from property they convey *inter vivos*, § 2036 encourages transferors to make absolute gifts — which are socially desirable. The property owner who is unwilling to forsake all benefits when making his transfer should expect to incur an estate tax burden commensurate with the property's value at his death. Absent estate taxation of the post-gift appreciation in value of property that was given away under an arrangement whereby vestiges of ownership are enjoyed by an *inter vivos* transferor, the gift tax becomes a foil for the estate tax. Rather, the estate tax should encourage absolute gifts during one's lifetime.

1. Without an effective measure barring valuation-freezes, the Federal estate and gift tax Chapters of the Internal Revenue Code present a playground for estate planners.

A. As now interpreted, existing § 2036(c) properly⁵ encompasses at least some grantor-retained income trust (GRIT)⁶ and self-cancelling installment note (SCIN)⁷ arrangements; any replacement provision must do likewise.

"GRIT" and "SCIN" arrangements enable transferors to gamble with Treasury funds. The transferor who anticipates his or her own longevity will enter into a GRIT arrangement, whereby an income interest will be retained for a term of years that is expected to end before the transferor dies. On the other hand, the transferor who anticipates a greater likelihood of his death before receiving the full value of transferred property via installment payments will go the SCIN route. In that case, the expected balance remaining unpaid on the installment notes that were accepted in a purportedly arms-length sale of the property will automatically be cancelled upon the transferor's death.

⁵For simplified explanations of recapitalization, by-sell agreement, installment sale, private annuity, split purchase, remainder sale, and grantor-retained-interest trust arrangements, see Bogdanski and Brown, *Farewell to 'Freezes'*: Section 2036(c), Tax Notes, March 27, 1989 at 1633, 1634-1637.

⁶See § 2036(c)(6).

⁷See § 2036(c)(1) and (2).

⁸A "GRIT" avoids § 2036(a) applicability by virtue of the transferor's living beyond the term of years during which an income interest is retained. The retained right is neither "for [the transferor's] life or for any period not ascertainable without reference to his death," nor "for any period which does not in fact end before his death," if the transferor's estimation of his or her own longevity proves correct, and so it escapes § 2036.

⁹Section 2033 might include the posthumously cancelled debt amount in a transferor's gross estate, but if the unified credit (amounting to a \$600,000 exemption-equivalent sum) is not exceeded there will be no transfer taxability at all. Moreover, the obligor recognizes no taxable income by virtue of § 102 applicability to the forgiven debt. The end result in economic terms is a bargain sale with neither gift nor estate tax consequences to the transferor.

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If the transferor chooses correctly as between these GRIT and SCIN alternatives, there will be an avoidance of estate taxability on all post-transferred appreciation in worth of the subject property — despite that the transferor has continued to enjoy economic vestiges of his or her former ownership following its conveyance. Even if the transferor makes the wrong choice, the estate tax implications will be no worse than if neither arrangement was attempted in the first place. Consequently, only the Treasury can lose, and only transferors can win.

B. The heart of the problem with all valuation-freeze techniques lies in the fact that gift taxes are minimized, if not completely avoided, in the initial phase of a transfer that ultimately enriches its transferee beyond any relationship to values includible in the transferor's integrated gift and estate tax base.

There has been some criticism of § 2036(c) as an estate tax solution to a gift tax problem,¹⁰ but in fact the gift tax aspects of valuation-freezing conveyances are rightfully negligible. It is appropriate that a transferor incurs gift taxation on only the donatively conveyed value of property, and equally appropriate that gift taxability is minimized or eliminated by the value of any tangible benefits that the transferor is scheduled to receive as a *quid pro quo* from his conveyance. Under freeze schemes, however, the estate tax is wronged whenever a transferor passes to his chosen beneficiaries property that holds the prospect of substantial future appreciation under circumstances that provide the transferor with post-transfer benefits disproportional to what the property conveyed is ultimately worth.

In a SCIN arrangement, because the transferor continues to reap an economic benefit from the property as a vestige of its ownership, valuation of the property for gratuitous transfer tax purposes is more appropriate at the time when its transferee's payment obligations to the transferor end, rather than when they begin. The same perspective on valuation, when the grantor's retained interest ends, should be taken in GRIT situations. Otherwise, these transferors will avoid incurring estate taxability appropriate to the appreciated value received by their beneficiaries.

C. Each of the popular valuation freeze arrangements manifests certain shortcomings in § 2036(a) which are being exploited; the statutory provision must be reinforced to compensate for these weaknesses.

Effective valuation freeze techniques frustrate § 2036(a) in one of two ways. The first is by transferors who receive substantial benefits from their transfers, but without any retained control or enjoyment of the very property that was conveyed. Examples of these transfer patterns in the current lexicon include SCINs and private annuity arrangements, both of which sidestep § 2036(a) by avoiding any retention of possession or income from the transferred property itself. The second popular means of undercutting § 2036(a) is via transfers that actually do involve a retained possessory, income, or managerial interest in the property conveyed. Transferors in these instances nonetheless escape estate taxation of the full value that eventually inures to their beneficiaries — either by timing their

¹⁰ Holden, *Turn Down the Heat on Estate Freezes*, CFO, May 1990, at 6: "All that was needed was a set of rules that would correctly value the common stock on which the gift tax was payable." This sentiment fails to take cognizance of the fact that valuation freeze transactions generally provide economic benefits to the transferor; a continued cash flow for the transferor warrants holding open the transfer tax implications of these arrangements.

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retentions to expire before they themselves do (the GRIT approach) or by embodying their retained rights in non-appreciating participatory ownership interests (as a limited partner or as a preferred stockholder following a recapitalization, for example).

By presently conveying only residual equity interests, which will carry with them all pre-death appreciation in the property's value, the transferor secures a best of all worlds result. Minimal exposure to gift taxation results because of the transferor's ongoing interest, which has the effect of virtually eliminating the element of gift. (This is particularly true of sale-structured transfers, such as an exchange of property for either a private annuity or a self-cancelling installment note.) At the same time, the transferor succeeds in positioning his transferee to receive the mushrooming, post *inter vivos* transfer value of the property — without any estate tax exposure of that appreciated value. Unless the Internal Revenue Code contains an effective statutory measure after the fashion of § 2036(c), that brings into the transferor's gross estate either the date of death or § 2032 alternate value inuring to the transferor's beneficiaries, these avoidance practices will go unchecked. Our integrated system of Federal taxes on gratuitous transfers, and the underlying theme of all three of the incomplete transfer provisions (§§ 2036, 2037, and 2038), would then be violated. Properly reinforced by valuation freeze barriers, however, § 2036 can continue to function in concert with its companion provisions promoting "no strings" gifts.

II. If § 2036(c) is to be replaced, then selected elements from certain existing estate tax provisions — specifically, §§ 2035, 2037, 2040, and a variant of the § 2042 "incident of ownership" concept — can be employed to cope with the valuation freeze problem.

A. A provision generally along the following lines is recommended if § 2036(c) is to be replaced.

The gross estate of a transferor who owns within three years of his or her death any vestiges of ownership from previously conveyed property, including property as may be shown to have originally belonged to the decedent or for which the decedent directly or indirectly provided consideration, shall include the date of death (or § 2032 alternate) value of such previously conveyed property; provided, however, that the preceding will not apply unless within three years of the decedent's death his or her vestiges of ownership have a value of 5 percent or more of the value of such previously conveyed property.

If it can be determined that at any time during the three-year period before death, a transferor held any vestiges of ownership comprising 5 percent or more of the value of property originally conveyed by the transferor (excepting property of which the transferor made an absolute conveyance without having any post-transfer vestiges), there would be Federal estate taxation of the originally conveyed property's value at the transferor's death or alternate date.

1. Given that the present § 2036(c) is criticized for its attempt to address corporate and partnership recapitalization arrangements by the vague "disproportionate share" standard, a percentage interest test is suggested as a readily measurable alternative.

The percentage triggering mechanism here proposed is obviously borrowed from existing § 2037. In the corporate recapitalization freeze context, for example, if a transferor were found to hold preferred stock interests that were worth 5 percent

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or more of the corporation (or portion of the corporation) previously conveyed, then the entire date of death or alternate value of all the ownership interests in such portion of the corporation would be includible in the transferor's gross estate for Federal estate tax purposes.

2. The proposed "vestiges of ownership" language — an obvious variation on the § 2042 "incident of ownership" concept — is needed to address private annuities, GRITs, and SCINs.

The "vestiges of ownership" language employed in the present proposal is an obvious variation on the § 2042 "incident of ownership" concept, the necessity for which is found in the private annuities, GRITs, and SCINs of the past.

It should be noted that in split purchase situations, if consideration paid for a remainder interest did not emanate from the decedent directly or indirectly, there would be no estate taxation of the property's value upon the life estate owner's death. In that case, the life estate would not be a vestige of what the decedent previously owned. Likewise, if a youngster's share of a business owned at one point entirely by elders were shown to have been earned as compensation for services performed by the youngster (for example, by its having been reported as income the employee youngster, pursuant to § 61 or § 83), there would be no inclusion of the value of any of the youngster's ownership interests in an elder owner's estate.

3. In order to reach certain split-purchase/remainder-sale arrangements, as well as exchanges for a private annuity, it should prove useful to incorporate the § 2040 concept of property or consideration that emanated from the decedent.

A derivation of the § 2040 language pertaining to property "as may be shown to have originally belonged to the decedent" is included in the proposal to reach certain split purchase/remainder sale arrangements as well as exchanges for a private annuity.

Incorporating a substance over form perspective into the statute, by borrowing the consideration-tracing rule from § 2040, should have the prophylactic effect discouraging attempts at an end-run. On the other hand, inasmuch as the new § 2036(c) as here proposed seems most appropriate for intrafamily or other related-party dealings and arguably would be out of place if applied in any other context, some cross-reference either to § 318 or to the more broad personal holding company attribution rules is fitting in order to limit its scope.

B. An end result of efficiency and effectiveness in our integrated Federal gift and estate tax system will be complete gifts, with no strings attached.

The three incomplete transfer sections (2036, 2037, and 2038) all serve the same socially desirable end of encouraging gifts with no strings attached. Such gifts *inter vivos* effectively disperse accumulated wealth, in keeping with the very reason our gratuitous transfer tax system exists.

It can be noted that *inter vivos* gifts are already encouraged by the tax base differential between our Federal gift and estate taxes. Any tax payable on a conveyance by gift is excluded from the gift tax base, whereas the estate tax computation on testamentary conveyances will include funds destined for payment to the Internal Revenue Service by dint of the estate tax. Moreover, given the tendency of assets to appreciate in value during periods of even modest inflation, the *inter vivos* donor incurs less tax on the lower value of gift-conveyed property.

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In order to promote outright gifts and assure horizontal equity among transferors of approximately equivalent wealth levels, it is necessary for the decedent's gross estate to include the full date of death (or § 2032 alternate date) value of property that was nominally transferred, but from which vestigial benefits were enjoyed by the *inter vivos* transferor.

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ELIAS CLARK

May 3, 1990

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth Building
Washington, DC 20515

Dear Mr. Chairman and Members of the Committee:

I regret that I was unable to attend the public hearing on the Discussion Draft to Modify Section 2036(c) of the Internal Revenue Code held on Tuesday, April 24, 1990. I am writing now to present my views for the record on three points:

1. Because the problems it addresses are real and substantial, §2036(c) should not be repealed without the enactment of a new statute to take its place; 2. The approach set out in the Discussion Draft for the taxation of transfers within the family of interests in a family business or partnership strikes a fair balance between the legitimate concerns of taxpayers and of the proponents of an effective transfer tax system and provides an appropriate basis for discussion and refinement prior to enactment; 3. The approach is not in my opinion well suited to correct the abuses that have developed from the use of GRITs, private annuities, joint purchases and similar trust devices. I believe that the recommendations set out in the Treasury Department Report to the President, Tax Reform for Fairness, Simplicity and Economic Growth (1984), provide a better basis upon which to construct legislation in this area.

The popularity of various estate freeze strategies and their capacity to transfer large amounts of wealth to younger generations of a family at little or no tax cost have been well documented and need not be repeated here. §2036(c), as amended in 1988, was enacted to counter these abuses. That legislation is not criticized for failure to achieve its objectives but rather for casting its net too widely and ensnaring business arrangements that do not involve freeze techniques. I am not convinced that §2036(c) is so lacking in merit or unworkable as to justify its abandonment without further effort to correct its deficiencies. Repair of §2036(c) is not, however, the issue here. Rather, interested parties are asked to comment on the form that substitute legislation should take.

My orientation is that of a trusts and estates professor, and I will focus most of my comments on the impact of the draft proposals in that area. It seems reasonably clear to me, however, that the draftsmen set as their primary target the corporate recapitalization. Trusts are secondary. I believe that the system they propose is well adapted to impose a fair and realistic tax on the interests that result from a recapitalization. The proposal lets the parties set their own terms, saying to them in effect, we will hold you to those terms and will establish the value of the interests and impose the gift and estate taxes accordingly. In this respect, it does not unduly intrude into business transactions that are made for non-tax reasons. The method of establishing values is simple and straightforward and thus can be administered with maximum efficiency. It identifies those retained interests that may be considered and directs that their value be subtracted from the value of the entire interest held by the transferor to set the value of the interests being conveyed to other members of the family. There will undoubtedly be debate on the details. For example, there may be additional claims held by non-family members against the transferor's retained interest that should be included in the valuation process. Further, it may be unreasonable to attribute control to a person who, with his hostile siblings, shares a 10 percent ownership of the entity. Presumably, the opinions of experts will be heard on these and other topics and a compromise struck. The basic structure remains sound and provides a solid foundation for taxing transactions among family members involving interests in a family business or partnership.

The trust sections are, in my opinion, seriously flawed. First, they should be separated from the larger whole, which is primarily concerned with transactions involving business interests, and presented as a distinct, coherent unit. At stake is not just the need to bring order to the confusion. The trust has a unique feature that must be uniquely dealt with. The transferor's retained interest does not remain intact as in the corporate recapitalization but rather diminishes in value each year until it ultimately disappears at the end of the specified term. Second, the draft is incomplete. It does not make clear what if any tax is to be imposed at the termination of the trust, makes no mention of the effect when consideration for the transfer is supplied by a transferee, and leaves to the imagination the manner in which the draft provisions are to be coordinated with §§2036(a), 2038, 2037 and 2035 of the estate tax and the provisions of the generation-skipping transfer tax. Finally, for the reasons outlined below, the proposed statute, depending on how it is construed, is either under inclusive, in which case the interests of the Treasury and Congress in preserving the integrity of the transfer tax system are not served, or over inclusive, in which case trust beneficiaries are called upon to pay a maximum gift and estate tax and are allowed none of the offsets that now appear in §2036(c).

Ambiguities in the draft statute are best revealed by making reference to an example of a grantor-retained-interest trust. Mother, age 40, transfers \$1 million to a trust that is to continue for a 30 year term. Pursuant to the mandate in §2701(b)(2)(B), she directs the trustee to pay her each year 6 percent of the fair market value (determined annually) of the property in the trust out of the income earned by the trust but, to the extent that the income is insufficient, to make up the shortfall out of principal. At the end of the thirty year term, the trust is to terminate and the assets paid to Mother's two children.

Using the method by which the value of interests in a unitrust is computed, the value of Mother's gift of the remainder to the children is \$163,460. If the Mother uses an annuity trust rather than the unitrust and sets the annual payments at \$60,000, the value of the remainder is \$434,390. Mother has made a gift of the remainder and will file an appropriate gift tax return.

The important question that next arises, and the one on which the proposed statute is ambiguous, is what, if any, additional transfer taxes will this trust be required to pay. The deemed gift provisions, which serve as a device to insure that stipulated payments set out in transactions involving the family business are actually paid, are not necessary to police trusts and will seldom, if ever, come into use. Performance of the trust obligations is insured by the fact that the trustee who fails to implement the terms of the trust will be in breach of trust and thus personally liable for the consequences of that breach.

The thirty year term passes, Mother's retained interest terminates and the appreciated trust corpus is turned over to the children. At this point under existing law, §2036(4)(c) treats the trust termination as a deemed gift from mother to children. The gift is equal to the amount that would have been includable in the Mother's estate had she died on the day the trust terminated, reduced by the amount of the original transfer that constituted a taxable gift. The amount of the gift may be further adjusted to reflect the fact that the donees are liable for the payment of the gift tax and that some consideration may have been paid for the transfer when made. In contrast to these elaborate provisions, the proposed statute is vague on the tax consequences of the trust's termination. The relevant section, §2701(d)(5) states that a "termination of an interest shall be treated as a transfer and any amount received on such termination shall be taken into account under paragraph (2)(B) whether or not such amount is a qualified fixed payment." The enigmatic language "taken into account" is inappropriate here -- there should be a clear direction as to whether the remainder is taxable or not. Nor does the reference to (1)(B) provide clarification. That paragraph talks about the fair market value of the fixed payment rights which, in the case of a GRIT, are the rights to income that have now terminated.

Statements made in support of the discussion draft indicate that the objective of the proposed statute is to insure that a true valuation of the initial transfer is made. It is said that freeze transactions are not abusive per se and that if accurate initial valuations are made the system is working correctly, even though future appreciation is not subject to estate or gift tax. Consistent with this statement of the overall policy, it can be argued that the ambiguous message of §2701(d)(5) should be construed to mean that there is no tax at the time of the GRIT's termination. The fixed payment requirement does achieve a true valuation of the interests at the time the trust is created. Thus, in the example, the \$163,460 value given to the remainder of a unitrust or the \$434,390 value of the annuity trust are realistic values, reflecting not only the remainder's present worth but also its potential for appreciation. By way of contrast, if a fixed payment were not set out in the trust instrument, the value of the remainder would be \$57,309. Also consistent with general policy objectives is the fact that the fixed payment requirement creates disincentives on the use of the GRIT to transfer property which is likely to appreciate but create little current income. In order to reduce the value of the remainder, the fixed payment percentage or amount has to be set high; but, in order to meet the annual payments out of income, the trust principal will have to be invested in high yield, low growth investments.

While there is a degree of plausibility to this reading of the draft statute, it marks a dramatic departure from the present operation of the estate and gift taxes and creates several major problems. If, for example, Mother died at age 65, five years before the term has expired, §2036(a) requires that the then value of the trust corpus be included in her gross estate. It is manifestly unfair to make taxability depend on the fortuity of whether or not Mother predeceases the term of the trust. One solution would be to extend the valuation option to grantors who create §2036(a) trusts. If the retained income interest is defined in terms of fixed payments, the grantor pays a gift tax on the correct value of the remainder but no estate tax at the time her death causes the trust assets to be turned over to the children. Coordination of §2036(a) and the draft provisions would require some adjustments. §2036(a) is broader in its sweep, imposing the estate tax on transfers where the grantor has not retained a personal right to income but rather has only the right to designate others who are to receive it. It also has been used in a number of cases where a parent has conveyed the family home to the children but has continued to live in it as before until his or her death. The proposed statute covers only personally retained interests and, in §2701(a)(4)(A), explicitly excludes from its provisions incomplete transfers such as a trust in which the grantor has retained the power to designate beneficiaries. Subparagraph (B) of that same section also excludes, for reasons that remain obscure, a trust that consists of a personal residence.

Dissimilarities in definitions, however, represent only the tip of the iceberg. A system that makes no claim for a tax on the assets at the termination of the trust poses a serious threat to the integrity of the estate tax. It should not be adopted for any number of reasons, four of the most obvious of which are: 1. Wealth owners view these trusts as the functional equivalent to a will. It follows from that assumption that trusts with income interests retained until or near to death have always been treated as quintessential testamentary transfers and the legitimate targets of any system of death taxation. 2. It is arbitrary and unfair to exempt such trusts from the estate tax while continuing to tax in the traditional manner trusts over which the grantor has retained only a power to alter, amend or terminate. 3. Congress and the Treasury have waged over the past decade a valiant struggle to subject appreciated assets to some form of transfer tax. The approach under discussion here represents a substantial retreat from that position. The initial valuation of a unitrust does to a limited degree value the potential for appreciation, but there is still room for the kind of abusive manipulation that §2036(c) was designed to discourage. 4. One's intuition suggests that a gift-tax-only approach will cause a significant reduction in the total revenues produced by the estate and gift taxes.

For those reasons and more it seems unlikely that the draft is intended to give away the store in this wholesale manner. Returning then to §2701(d)(5), it can be argued that "take into account" means "subject to tax as a deemed gift" and "amount received" means the full market value of the trust without any offset for the fixed payment income interest which has now expired. But this construction is equally unsatisfactory. Indeed, it is a continuation of the present §2036(c) with the ante upped in two ways. First, it double dips in that it subjects the potential for appreciation to gift tax and the actual appreciation to estate tax. Second, it omits the offsets which were included in the deemed gift provisions of §2036(c) in fairness to the parties.

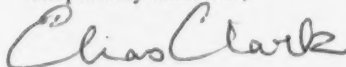
Section 2036(c) grants an offset for bona fide consideration supplied by the transferee. The draft appears to proceed on the assumption that the transferor is the source of any and all consideration. Although this may well be the typical situation, the exceptions present a problem. For instance, §2703(d)(2) concerning joint purchases states that if mother buys the income interest and the daughter the remainder the mother is to be treated as the transferee of the remainder to the daughter. This result is fair enough if the mother supplied the consideration by which the daughter brought her interest. If, on the other hand, daughter used her lottery winnings, mother is being taxed for property she never owned nor transferred. This is an extension of the taxing authority beyond constitutional limits.

The recommendations set out in the Treasury Department Report to the President, Tax Reform for Fairness, Simplicity and Economic Growth (1984), reverse the order in which the taxes are imposed from that used in the discussion draft. In the words of the Report:

Retained beneficial enjoyment. The proposal would simplify present law by providing that a transfer tax would be imposed only once, when the beneficial enjoyment retained by the donor terminates. Thus, if a donor makes a gift of a remainder interest in property, but retains the intervening income interest, no gift would occur until the termination of the donor's income interest. At that time, the property would be subject to gift or estate tax at its full fair market value. Because the transferor would be treated as the owner of the property during the interim, any distributions made to beneficiaries other than the transferor would be treated as transfers when made. . . .

These recommendations have their own set of special problems. Nevertheless, the approach set out therein seems to me to provide a much more promising starting point for discussions as to means of meeting the trust abuses that gave rise to the enactment of §2036(c). It conforms to the traditional definition of a testamentary transfer, fully taxes the appreciated property from which the grantor has been deriving benefits for the period of his life or the term of the trust, and, because it does not represent such a revolutionary departure from existing concepts, will be more easily understood and thus more readily accepted.

Respectfully submitted,



Elias Clark
Lafayette S. Foster Professor
of Law

WRITTEN STATEMENT

by

David E. Lajoie
Partner
Coopers & Lybrand

Hearing Before House Committee on Ways and Means
U.S. House of Representatives
April 24, 1990
on
Estate Valuation Freezes "Discussion Draft"

Mr. Chairman and Members of the Committee, I am pleased to provide our analysis to the Committee on the discussion draft of a bill to repeal §2036(c) and to replace it with special valuation rules. I am submitting this statement on behalf of my firm, Coopers & Lybrand, an international accounting firm.

We commend you, Mr. Chairman and Members of the Committee, for recognizing the misguided approach of current §2036(c) and proposing a framework that both repeals §2036(c) and replaces it with an approach that appears more reasonable and responsive to perceived abuses in the estate freeze area.

The problems with §2036(c) stemmed, in part, from a desire to stamp out all possible means of avoiding transfer taxes in the family context. This desire to enact an all-encompassing provision resulted in a provision that placed all family businesses in jeopardy of having even minor transfers of property to relatives produce unexpected and sometimes disastrous consequences upon the death of the business owner. With the history of §2036(c) in mind, we offer the following analysis of key provisions of the discussion draft.

We endorse the conceptual framework upon which the discussion draft is based. The government is entitled to receive transfer taxes on the legitimate fair market value of transferred assets. The overvaluation of certain retained rights in the family context has in the past subverted this goal.

However, the discussion draft does not accomplish the goal of basing the transfer tax upon true fair market value. It is our opinion that the provisions of the discussion draft should be revised to reflect simpler valuation rules that will go a long way to reaching this goal without being unduly burdensome.

1. The special valuation rules would apply to family transfers of interests in 10-percent owned entities. The potential for abuse is minimal where an element of control is not present. The threshold for application of these rules should be increased to a more objective ownership level of 50-percent.

The ability to cause a change in the capital structure of an entity (i.e., recapitalization, redemption, etc.) is not present in real life without some element of control. The element of control is necessary to accomplish any type of discretionary payments or changes in capital structure. The discussion draft establishes an arbitrary 10% threshold that has no correlation with control, particularly when considered in conjunction with the family attribution rules and the indirect ownership rules. In a situation where a 10% total interest in an entity is owned by an individual, his family members (including siblings, parents, children, and spouses), and indirectly through entities in which by these persons own an interest - the individual simply is not generally in a position to impose his will on the unrelated and sometimes adverse owners of the remaining 90% interest.

In addition, the inclusion of siblings and their spouses in the definition of family for attribution purposes is not reasonable. Typically, parents and children will have

similar interests and concerns that are not present in a brother and sister context. Each brother and sister has their own interests and the interests of their family (spouse and children) as a primary concern. Therefore, it is not reasonable to presume that they will act in concert when, in fact, they may have adverse interests.

This sibling rule is also inconsistent with other definitions of family in the Code. Although §267(c)(4) includes siblings (but not spouses), it is a related party rule that has nothing to do with constructive ownership. Section 318 of the Code deals with constructive ownership of corporate stock and does not include siblings in the definition of family.

Present §2036(c) is too ambitious in scope. It is urged that the replacement be less pervasive and that the 10% requirement be dropped in favor of a more objective 50% threshold. Fifty percent is less arbitrary and control would be a valid consideration. In addition, the inclusion of siblings and their spouses in the attribution rules should be eliminated.

2. The minimum value of a transferred junior equity interest cannot be less than the proportionate share of 20% of all equity and any debt owed the transferor or his family.

The requirement that 20% of the equity be represented in the appreciating portion of the business is an arbitrary rule. The gift tax cost associated with transfers subject to this rule could make legitimate transfers prohibitive. Selection of 20% as the minimum value has no real world basis. If an arbitrary minimum value is to be imposed, it is recommended that it be a more nominal arbitrary amount, say 5-10%.

3. The Chapter 14 valuation rules would create serious cash burdens upon a typical family business.

- a. The 20% minimum value that must be attributed to the appreciation element will in many cases result in a large upfront gift tax payment. It is suggested that a deferral gift tax payment provision, similar to §6166, be included. In many circumstances the transferor will have only one major asset, that is the family business, with resulting cash-flow problems.
- b. A QFP (Qualified Fixed Payment) will be valued so long as it has a required payment related to an appropriate market rate of return which may be artificially high. This could also create serious cash-flow problems for the typical family business. First of all, market rates do not necessarily take into consideration the cash requirements of day-to-day operations. Secondly, these types of entities typically are successful because earnings and profits are put back into the entity for capital expansion and capital improvement and cash for dividends may not be available. In addition, less successful businesses will also not have the cash available. Requiring a pay-out in such an environment is counterproductive and unfair.
- c. Assigning a zero value for an interest that is not a QFP is unrealistic and does not necessarily reflect true fair market value. For example, a noncumulative dividend right is a right with some real value and should be allowed to have that appropriate value assigned to it based on the financial and other circumstances existing in the particular case.

4. The overall complexity of the Chapter 14 valuation rules raises the concern that the change is being made from one complicated set of rules to another complicated set of rules. The concept of concentrating attention on the valuation of the original transfer is good - the rules proposed to accomplish this are not.

The similarities to §2036(c) contained in the discussion draft are troubling. For instance, "entity" has been substituted for "enterprise" and the broad scope of §2036(c) is a problem all over again. The replacement statute should concentrate on the significant sources of valuation abuses that exist in a preponderance of cases. Simple rules should be devised that apply to these main valuation areas. The rules should promote ease of administration. For example, the extension of the statute of limitation will be difficult to administer, as will deemed gifts in future years, and overpayment and refund adjustments. The situation could arise in which the statute of limitations continues for an older year subject to the special valuation rules while the statute of limitation has already run on a later gift tax year not subject to these special rules. Administratively, such a situation may require a 6-year statute of limitation for all gifts. The good of creating certainty by a completed gift will also not be accomplished as these rules will ultimately have an effect on decedents and their estates.

5. These rules reflect Congress' continued search to find the appropriate amount of transfer tax to be imposed on the transfer of ownership and management of the family business from one generation to the next.

The family business has proven important in our nation's history. The family business has produced new ideas, new products and services, and new jobs. The innovation and risk-taking that has been largely responsible for the successes of family businesses has not been as evident in the publicly-held companies in our country.

Section 2036(c) is a harsh rule for the family business and the time has come for it to be replaced. It is suggested that the Committee think in terms of relief provisions like §303 redemption provisions and the §6166 deferred estate tax payment provisions. The excellent concept of focusing on fair valuation is in danger of being consumed by a set of arbitrary valuation rules that apply to transfers of ownership of the family business as distinguished from the valuation rules applicable to other assets.

6. Additional areas of concerns and comment:

- a. Establish a de minimis rule for transfers that will be subject to the Chapter 14 rules such as something similar to annual exclusion gifts.
- b. Clarify the terminology in §2703(d)(4) that concerns a term interest that would not have a substantial effect on the valuation of a remainder interest in property.
- c. The effective date of the new provision should not be prior to the date of enactment and should include a transition rule for transactions not completed but subject to binding contracts.
- d. The treatment of joint purchases by family members as a purchase and transfer by the term interest holder should not apply where consideration is paid by the purchaser of the remainder interest.
- e. There is confusion as to how basis rules will work for §1014 purposes for valuations subject to Chapter 14 where the value of the retained rights exceed fair market value.

Because a number of unresolved issues remain, we recommend that a practitioner group be organized to work with the Committee, and other interested parties, to develop a workable solution. We appreciate the Committee's concern and are available to assist you in any regard.

MEANS CORPORATION

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The Honorable Dan Rostenkowski
 Chairman Committee on Ways and Means
 U.S. House of Representatives
 1102 Longworth Building
 Washington, D.C. 20515

May 7, 1990

Subject: Section 2036(C). IRS Code

Dear Congressman Rostenkowski:

My God, my family, my country and my company. I'd like to hold onto all four, but the odds are against the Sullivan's keeping the company we started and sacrificed to keep alive these past twenty years.

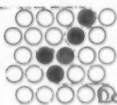
My wife and I started Dunmore Corporation in 1970 when I was 41 years of age with \$10,000. of our own money and \$42,000. from outside investors.

We had 9 children then; have added two since, one having Downs Syndrome. Of the 11 children, 8 are part of the 190 people currently employed in the company which now provides jobs for people in two States with sales in the \$25,000,000. range.

In our case, the company would never have survived if it had not been for the cooperation of our children, and for this they will be heavily penalized at our deaths. You see, they did not ask for equity in the business; they only asked what they could do to help.

Over the years we had to re-mortgage our home more than once, had to borrow from my in-laws to meet accounts payable, borrow from our oldest son to avoid missing a payroll, and have had all the usual problems of keeping a young under-capitalized company from going under. So far the company has survived. But can it continue?

It is doubtful the company can survive as a family owned business because we constantly reinvested profits in the business to grow the company. The Federal Taxes, as they now stand, mean there is no option except to sell the business to pay the Federal Estate Tax when we, the parents die. 2036 C as it stands or as it may be amended, really says that the family that works together is indeed very foolish. My children will be forced to go into debt for over fourteen years to hold onto the company they helped create.



Does the Dunmore Corporation make any United States arrangements, even
 DUN-PRINT® DUN-KOTE® DUN-BRITE® DUN-TRAN® DUN-LAP® DUN-RAY®
 DUN-MET® DUN-GUARD® DUN-THANE® DUN-FAB® DUN-LAMP®

Does this help make the United States stronger? Then, even if they were able to somehow pay the taxes, their children will be faced with the same problem. As individuals and as business owners we pay our taxes. Why is the Congress so interested in tearing down job producing, tax paying enterprises?

I suspect this American family oriented business will go to the highest bidder from Japan, Germany or England because the Congress is more interested in collecting taxes than rebuilding the United States into the strongest industrial nation providing jobs, health and educational benefits to those who are not afraid to work.

However, offshore "unfair" competition and the various government regulations at all levels seem to be in concert against that which the United States originally professed; the land of opportunity for those that are willing to work hard to succeed.

Why is it we defeat ourselves but blame others? The current motto of the American business man therefore has to be, "think short term profits; don't build for the future, take the money and run." Unfortunately for the United States, the other industrial powers clearly take the opposite view and are in disagreement, as I believe, so would be our founding fathers.

The Congress is failing American business and therefore the American people. "Atlas Shrugged"; it only took longer than Ann Rand expected.

Please let me know if there is anything I can do to assist you in preventing more regulations - laws - codes that strengthen other nations and weaken ours. As a people we should be encouraged to save and build instead of spending every cent and borrowing more to spend more. And, Congress should be leading the way by setting good example.

Most sincerely,

M. L. Sullivan

Michael L. Sullivan, President
Dunmore Corporation

MLS/mas

FAMILY BUSINESSES OF AMERICA

301 North Main Street, Wichita, Kansas 67202, Phone: 316-291-8352, Fax: 316-291-8354 or 8318

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Washington, D.C.

Leonard Zweig, Pres. & Pub.
Family Business Magazine

For release upon delivery May 3, 1990

STATEMENT OF FAMILY BUSINESSES OF AMERICA ON SECTION 2036(c)

John K. Garvey, Executive Director

To: Committee on Ways and Means
United States House of Representatives

Re: I.R.C. Section 2036(c) Repeal; Support of H.R. 60,
remarks regarding Discussion Draft Gift Tax
Substitute

Mr. Chairman and Members of the Committee:

With the continuation of Section 2036(c) and some of its proposed substitutes, family businesses may well become America's newest endangered species. (Please see Footnote 1.)

Family Businesses of America is a non-profit trade Association whose mission is to serve as a voice for many of America's 20 million family businesses who employ perhaps half the American workforce and represent at least 1/3 of the U.S. G.N.P. Our estimate is that family businesses and farms directly, substantially and materially affect over 100 million Americans through employment or an equivalent daily impact.

Though we were formed in 1990, we already have members in essentially all economic sectors and industries, all regions and in most states.

As such, our goal is to help protect the critical national resources represented by family-owned, closely-held owner-managed businesses in America.

We aspire to represent and respond to family businesses needs and interests and to educate and communicate the vital role of family businesses to legislators and administrators and the American public and media.

We seek cooperation and communication with other trade associations and so are a Founding Member of The Coalition for Preservation of American Family

1

Family Businesses of America is a non-profit, non-partisan education organization dedicated to the preservation of family businesses of all sizes and kinds. Personal and corporate contributions are welcome.

Founding Member of The Coalition for Preservation of American Family Businesses

Businesses. (SAFE, or Safeguard America's Family Enterprises, shares this agenda.)

Many of America's foremost trade associations including NFIB, SBLC, U.S. Chamber, NAM, National Grocers Association, National Association of Wholesaler-Distributors, American Truckers Association and countless others are comprised of a majority--sometimes an overwhelming majority--of family business members.

Family businesses range from "Moms-and-Pops" to over three hundred (>300) members of the Fortune 1000 (10% or more owned by a family) to most farms, many newspapers, magazines and broadcast properties, most groceries, many banks, large and small manufacturing concerns, distributors, high-tech to no-tech concerns, most start-ups, and the majority of firms accounting for most new-hires. (Additionally, most Fortune 500 firms were once family businesses; by extension, how many potential Fortune 500 companies of the future may be prematurely aborted by 2036(c) and adverse gift tax policies?)

Indeed, family-owned businesses are much of what America is all about.

Also, since an estimated eighty percent (80%) of all businesses world-wide are family-owned, family business is the primary mode and context for global competition in a future with increasingly globalized markets. (Please see Footnote 2.)

In an era of generally declining U.S. balance-of-trade, by systematically handicapping U.S. family businesses with Section 2036(c) and some threatened gift tax substitute initiatives, the U.S., through its tax policy, threatens to systematically handicap its own global competitiveness by burdening our greatest competitive weapon, our greatest source of new jobs and greatest risk-bearing sector, family businesses, with rules and taxes that place American family businesses--and so the larger U.S. economy--at a competitive disadvantage vis-a-vis non-U.S. family businesses.

Our positions may be summarized succinctly:

1) We favor retroactive repeal of 2036(c), as does SBLC and Chairman Rostenkowski. We also favor immediate repeal of 2036(c) followed by a period for study of various replacement alternatives.

2) We support H.R. 60 and S. 849. We note that since April 23, 1990 there have been at least 218 co-sponsors in the House for H.R. 60 (repeal of 2036(c)), representing a majority of Members of Congress. This suggests the wisdom and desirability of immediate passage of H.R. 60.

3) We are opposed to the proposed gift-tax Discussion Draft Substitute in its present form. We agree with the ABA, AICPA and others that it is overly broad, vague, extremely complex, and addresses types of transactions, e.g., buy-sell agreements and G.R.I.T.s and others which are essentially never employed in an "aggressively abusive" manner and which should not be included in any contemplated changes.

a) Also, we are strongly opposed to extending the three-year statute of limitations on gift tax valuation.

b) Additionally, the very concept of taxing a right of future appreciation represents discriminatory double- or triple-taxation of a family business--once at the earned income tax level and once at the gift tax level--as well as conceivably a third time at the capital gains

level. Also, the very concept of "soak-up rights" represents a muddled and flawed valuation concept that has no place in valuing a business from an established valuations perspective and certainly not from a tax perspective, in our opinion.

Indeed, it is unfair and highly inequitable to discriminatorily tax children for increasing the value of a company when no other classes of owners of other businesses are taxed for improving the value of a business once they have acquired a partial ownership in it. To arbitrarily tax businesses differently in this manner merely because they are formally family businesses represents adverse discrimination against owners by virtue of their being family owners.

Moreover, to bring in "soak-up rights" or "rights on future appreciation" as subject to the above-mentioned double- or triple-taxation (first as taxation on the income stream, next as capital gains, and thirdly as estate or gift taxes) has obvious grave potential implications adverse to enabling and motivating family heirs to grow a business should they acquire it; indeed, such a provision would make family businesses handicapped on the competitive playing field.

Furthermore, this discriminatory estate and/or gift tax format provides a disincentive to continue a business as a family business and provides a complementary incentive to sell the business to strangers or outsiders, including particularly, larger public companies. Is this good public policy? We answer emphatically in the negative - it reduces diversity, competition, employment, risk-taking, experimentation and the long-term perspective that family-owned firms bring to the economy.

We view 2036(c) in effect as being a forced, hostile, leveraged buy-out/hostile takeover of U.S. family businesses by the IRS. It is leveraged because it forces many businesses to go into debt to pay taxes. It is forced because it uses the coercive mechanism of the Tax Code. It is hostile because it in many thousands of cases has eliminated family businesses which might well have otherwise survived, and with those businesses it has eliminated hundreds of thousands of jobs and economic resources in hundreds of U.S. communities, in hundreds of Congressional Districts. (U.S. Small Business Administration (SBA) estimates 85% of small U.S. corporations and 57% of small business partnerships are family businesses; they account for at least 1/2 of all U.S. jobs, 1/3 of the GNP, and probably 75% of new hires.)

Congress and states often oppose hostile takeovers of domestic corporations. Ironically, 2036(c) and measures like it are far more pervasively harmful than a single takeover.

We support the numerous excellent arguments that have been put forth by AICPA, NFIB, the U.S. Chamber, the ABA, the National Grocers Association and others favoring repeal of 2036(c).

We would call attention to these arguments and to the taxpayer compliance argument put forth by the American Bar Association in its September 1988 paper on 2036(c).

We call attention to and support NFIB's and the U.S. Chamber's argument that 2036(c) unfairly taxes children by taxing their parents estate even though the children may often by the cause of the firm's increase in value.

We support AICPA's argument that 2036(c), and, by extension, ambiguous and complex gift tax law changes, unfairly burden small and medium sized family businesses who cannot afford,

in time or money, or who are not aware of, the nearly annual changes in inheritance (and now gift tax) rules.

At the same time, like SAFE, we are opposed to any laws which would discriminate against family businesses by size--large or small--by fundamentally changing tax rules according to an arbitrary size demarcation.

We believe that since the Kennedy tax cuts of the early 1960's, our economy has demonstrated the supply-side thesis that reducing marginal rates may, through multiplier effects, increase Treasury revenue by stimulating the natural economic dynamism of a free market economy.

Conversely, taxing otherwise dynamic and risk-bearing family businesses out of existence through estate or gift taxes quickly leads to less jobs and less revenues to the Treasury.

Family businesses as entrepreneurial enterprises are the diametric opposite of the entropic centrally planned economies of the PRC, the U.S.S.R. and of Eastern Europe, which are now rapidly collapsing.

I have visited, as have many of you, Korea, Taiwan, Hong Kong, Thailand and the Philippines, which are primarily and essentially family-business models involving the world's most dynamic, productive, competitive and expansive economies. (I believe Singapore and Malaysia may also be accurately described as both high-growth economies and "family business" societies.)

I have also visited, as have many of you, PRC and the U.S.S.R. which have been heretofore extreme anti-entrepreneurial regimes and the polar opposite of a "family-business economy".

Threatened new, vague, overly broad and complex gift tax rule changes as well as the extremely broad, ambiguous, punitive and confiscatory IRC Section 2036(c), both push us toward an "anti-family business economy" and toward an economy of entropy through excessive taxation and bureaucratic regulation which diminishes U.S. economic and trade power and thereby shortens and diminishes American political power, by harming the greatest group of resources and human assets in our economy--American family businesses.

American family business is, after all, much of what America is all about! Let's take it off--and keep it off--the Endangered Species List!

Thank you for your courtesy, attention and consideration. We stand available to work with Congress, staff and Treasury, as needed.

FOOTNOTES

1) Even without complex, ambiguous, overly broad and confiscatory tax policy, only 35% of family businesses survive the transition from first to second generation, while only 15% make it to the third and only 5%, at most, make it to the fourth generation. Yet those who do represent some of the most respected and important U.S. corporations, often corporations which provide community and corporate leadership models.

2) Family businesses have other systematic advantages which augur well from a public--as well as private--policy standpoint. First, they tend, systematically, to look at the long-run--beyond short-term quarterly earnings reports--toward long-

term investments and long-term effects of decisions. Second, they tend to be civic-minded and community-minded. Third, they tend, statistically, to have high ethical standards, partly because the founders' family name is often attached. (See April 1990 Family Business magazine.) Fourth, they tend, systematically, to have better financial returns, due in part to the owner's shadow in management as well as the above-mentioned long-term perspective and commitment. (Pitcairn and Wharton empirical studies strongly statistically support the latter statement regarding family-controlled public corporations.)

STATEMENT
OF THE
FAMILY HOLDING COMPANY GROUP

Re: Repeal of Section 2036(c);
Replacement Discussion Draft

The Family Holding Company Group is an organization of twenty-four family companies which is concerned with the impact of federal tax policy on family companies in general and family holding companies in particular. Family holding companies are companies that either have a portfolio of investment assets, such as publicly traded securities, or which control or are associated with actual family-owned operating businesses. The stock of these member holding companies is owned by family groups and is not actively traded.

Family investments held through holding companies are subject to an unfavorable tax regime under present federal tax law:

- (1) Families which hold investments or operate active businesses directly, or through partnerships and S corporations, are taxed at a maximum income rate of 28 percent; whereas corporations (including family corporations) are taxed at a maximum rate of 34 percent.
- (2) Unlike publicly held companies, mutual funds, real estate investment trusts and other corporations, a family holding company is either subject to the personal holding company tax of section 541 or the accumulated earnings tax of section 531, so that family holding companies must either distribute all or most of their earnings or be subject to these penalty taxes.
- (3) Due to the erosion of the dividend received deduction (now only 70 percent), dividend earnings received by these companies are subject to *triple* tax (*i.e.*, at the level of the payor corporation, the family holding corporation and the individual shareholder).
- (4) At the death of a family holding company shareholder, large amounts of estate taxes must generally be paid even though the decedent's shares are unmarketable.

Because of this punitive taxation, almost every member of our Group would liquidate if it could do so without being subject to another prohibitive tax -- this one on the appreciation in the assets held by the company. Congress has imposed an unfairly discriminatory level of taxation on investments held through family companies at the same time making it prohibitively costly to change the structure of such investments.

In light of the highly unfavorable income taxation of family holding companies, the enactment of section 2036(c) in 1987 and its troublesome amendment in 1988 were severe blows to our membership. Shareholders of family holding companies suffer to the same degree as any other shareholders of family companies under section 2036(c), but they may not qualify for extended estate tax payments under section 6166. Consequently, in light of the existing duplicative and unfair taxes on family holding companies and for the many other reasons cited by numerous persons at the Committee's hearing on April 24 and in related written submissions, we urge the immediate repeal of section 2036(c) with retroactive effect to December 17, 1987. Failure to repeal this overbroad and inequitable legislation would expose shareholders in members of our Group to inestimable and potentially disastrous estate taxes.

With respect to the discussion draft, we share the view of many others in commending the Chairman for introducing this substantial improvement to present section 2036(c). Also like many other organizations which have submitted statements which comment on this discussion draft, we believe that both substantive and technical improvements are required in this draft. In order to avoid repetition, we particularly associate ourselves with the substantive comments of the U.S. Chamber of Commerce of April 24, 1990, and will limit our own comments to only one of these issues of substance.

We strongly object to proposed section 2702 of the discussion draft which would require that certain options (or agreements) be disregarded in determining the value of an interest in any family business. There is no dispute that family businesses frequently use and genuinely need such options (or agreements) for *bona fide* non-tax business reasons (*e.g.*, to prevent sales to hostile outside interest, to protect the family business in cases of divorce, bankruptcy, etc.). Present law simply evaluates whether any such options (or agreements) have any real impact on the fair market value of such interest in the family business. If it does not actually reduce the price a willing buyer would pay a willing seller, then it does not reduce the value for transfer tax (estate, gift and generation-skipping) purpose. If it does actually reduce such price, then this is recognized also for transfer tax purposes. Thus, present law gives options (or agreements) no more or no less significance than any other fact or factor that is considered in determining fair market value. Long-standing Treasury regulations expressly address and prevent any abuse in this area. Reg. § 20.2031-2(h).

Section 2702 would create an exception to the general fair market value standard; such an exception is unnecessary, unfair and very bad tax policy. Congress should certainly not be adopting exceptions to long-established and well accepted tax policy for the purpose of *increasing* gift and estate taxes on interests in family business. This is particularly egregious where the statute seems to be designed to force sales of family corporations.

Neither section 2702 of the discussion draft nor any comparable exception to the fair market value standard which denies equal treatment to family business should be adopted. Congress should be encouraging family business by the repeal of section 2036(c) and not penalizing family business by adopting provisions such as section 2702.

George W. Helme, IV
Executive Director
of the Family Holding Company Group
and —
Vice President, Wilmington Trust Company

GREATER PHILADELPHIA CHAMBER OF COMMERCE
GOVERNMENT AFFAIRS DEPARTMENT

STATEMENT ON SECTION 2036(C)
THE ESTATE TAX FREEZE

The Greater Philadelphia Chamber of Commerce supports a full repeal of the current Estate Tax Freeze rules, which have created extreme difficulties for the transfer of family-owned companies between generations.

While the chamber supports full repeal, as proposed by Rep. Bill Archer, we also recognize the concern of some Members of Congress over the potential for abuse by some individuals seeking to avoid the payment of appropriate estate taxes.

The draft legislation being considered by the Ways and Means Committee, if passed, will be an improvement over the existing rules. This Chamber and other business organizations believe, however, that a number of changes should be made to the draft for the bill to be fair to the family-owned business in this country. Several of the requirements will make estate planning more costly and complicated for the small business person. We cannot endorse the bill in its present form, but do believe the committee is taking a better approach than is currently in place.

The Greater Philadelphia Chamber of Commerce offers the following comments on the draft bill:

1. The Chamber favors the valuation method of calculating estate taxes over the incomplete gift method. The valuation method allows a parent to freeze his or her interest and pay the appropriate gift taxes at the time of the freeze without penalizing the future growth of the business.

2. The language contained in the draft bill for buy-sell agreements is not practical and unfair. Of particular concern are: provisions which require all buy-sell agreements to be re-negotiated every three years in order to be considered valid by the Internal Revenue Service; (this requirement is prohibitively costly for a person to undertake every three years, and drives up the cost of the estate taxes paid), and ignoring the Rights of First Refusal for dependents when purchasing stock upon death of the parent. Without giving the children the right to purchase the stock at an agreed-upon price prior to opening the purchase to outsiders, the family could lose control of the business they have worked so diligently to improve and grow.

3. There should be a formula used by the IRS to give the business a fair amount of time to pay the tax, rather than requiring full payment at once. Deferring the payment of the taxes over time, without incurring high rates of interest, would be less of a burden to the small business.

HOPKINS & SUTTER

(A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS)

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DALLAS OFFICE 548 EAST JOHN CARPENTER FREEWAY 75082

May 4, 1990

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This statement is submitted for inclusion in the printed record of the public hearing held on April 24, 1990 on the Discussion Draft relating to estate valuation freezes. Our comments are presented on behalf of this firm and not with respect to any particular client. We recommend that any legislation being considered as a replacement for Section 2036(c) of the Internal Revenue Code retain the so-called "statutory GRIT" provision of Section 2036(c)(6). Alternatively, if the statutory GRIT is not going to be retained, we recommend that any legislation which adversely affects statutory GRITs be enacted on a prospective basis.

The Discussion Draft of March 22, 1990 effectively precludes the utilization of Grantor Retained Income Trusts (GRITs) as a viable estate planning technique. In 1988, after careful deliberation and extensive study, the Committee added a safe harbor for so-called "statutory GRITs," in new Section 2036(c)(6) of the Internal Revenue Code. This provision was enacted in the Technical and Miscellaneous Revenue Act of 1988. The safe harbor applies for transfers to a trust in which the transferor/grantor retains a right to receive amounts determined solely by reference to income from trust property if the term of the right does not exceed ten years and the grantor is not a trustee of the trust. The Discussion Draft effectively eliminates those GRITs currently permitted under Section 2036(c)(6) by valuing the retained interest at zero and taxing the entire value of the property involved in the transaction as a transfer from the holder of the retained interest to the holder of the remainder interest.

The Honorable Dan Rostenkowski
May 3, 1990
Page Two

The Discussion Draft treatment of GRITs represents a complete reversal of the tax policy adopted by the Committee and Congress barely two years ago in their enactment of the statutory GRIT provision. As a matter of fairness and equity, and to ensure stability in estate planning, the statutory GRIT provision of Section 2036(c)(6) should be retained. As a matter of sound tax policy, the statutory GRIT has had the salutary effect of encouraging lifetime transfers of wealth.

If the Committee feels it is necessary to address this area again after only two years, any changes should be made on a prospective basis only, to become effective after the date of their enactment. Additionally, transitional relief should be made available to those taxpayers who acted in reliance on the statutory GRIT provision. Taxpayers should be permitted to unwind, without adverse tax consequences, any GRITs that were adopted in reliance on existing law.

We appreciate this opportunity to present our comments on this important issue.

Respectfully submitted,



William C. Weinsheimer

**Correcting the Error in Method of Calculating Interest
on Estate Tax Deferred under Sec. 6163(a)
Relating to Extension of Time for Payment
of Estate Tax on Value of Reversionary or
Remainder in Interest in Property**

This statement is submitted by John B. Huffaker of Pepper, Hamilton & Scheetz, 3000 Two Logan Square, Eighteenth and Arch Streets, Philadelphia, PA 19103 for inclusion in the present record of the hearing held on April 24 relating to Estate Valuation Freezes.

Very similarly, Congress erred when it case aside the method of computing interest on estate tax deferred under sec. 6163(a). This provision allows an executor to defer paying estate tax on a remainder interest until the prior interest terminates and the executor entitled to possession of the assets that generate the tax.

While the Ways and Means Committee is reconsidering its actions with respect to estate freezes, it would be appropriate to correct the rules by which the interest on deferred estate taxes on vested remainders is computed. (Sec. 6601 imposes the interest on deferrals under sec. 6163(a)). Correction of this section has been the subject of several bills, the most recent being H.R. 1214 of the 101st Congress, introduced by Mr. Schulze on behalf of Mrs. Boggs, Mr. Anthony, Mr. Murtha and himself. H.R. 5484, with the same sponsorship had been introduced in the 100th Congress. The Ways and Means Committee had previously approved a measure relating to the problem as part of TAMRA (Sec. 10407 of H.R. 4333).

The problem is as follows. A decedent may have possessed a remainder interest in a trust that would entitle the possessor of the remainder to possession of the trust corpus at a future date, - typically, when the present income beneficiary dies. This remainder is an asset includible in the decedent's gross estate. Its value is the present value of the corpus discounted for the fact that it will not be received until the income beneficiary dies. Since the executor won't possess the trust corpus until that time he is permitted to defer paying the tax until death of the income beneficiary (Sec. 6163). The executor must then pay the tax plus interest. The interest rate under current law is the same as it is for income tax deficiencies, which means that it varies from month to month. The hardship arises when:

(1) The remainder is a large part of the estate so there may be no alternative to deferring payment. When the

remainder is over 45% of the estate, taxes may absorb the entire balance of the estate.

(2) Due to changes in the economy, the applicable interest rate varies importantly from the discount rate.

The bill provides that in the instances like those described in (1) the interest rate will always be the one that is originally applicable. This produces an appropriate interest burden, since the interest rate and discount rate were determined at the same time.

In order to minimize the revenue impact, H.R. 1214 has been amended to provide that in the case of elections under Sec. 6163 open on the effective date (as well as subsequent elections) the relief is extended only to estates that are composed largely of remainder interests. The Joint committee on Taxation estimates a revenue loss of \$2,000,000 in 1991, \$1,000,000 in 1992 and negligible amounts in other relevant years.

H.R. 1214 including the amendment is attached (added material underscored).

Present law can produce an outrageous result, particularly when the current interest rate is much higher than that prevailing on the date of death. In fact, the tax plus interest can amount to two/three times the value of the asset when the period of deferral is a long one. For example, a trust provides donor's spouse a life income and then a person with a vested remainder is entitled to the corpus when the spouse dies. When the remainderman predeceases the spouse, the remainder is valued by discounting the value of the corpus for the life expectancy of the spouse at the prevailing discount rate (the same as the current interest rate). If, therefore, the interest rates double, the high current interest rate imposed on the estate tax computed on a much lower discount value can quickly lead to a total (tax plus interest) burden in excess of the corpus value.

Present law does allow some deferrals that are not hardships although the interest rate on such deferrals is the same as that for hardship deferrals. There is no obvious need to separate the two types so that the right of deferral of tax on remainder interests is narrowed to those in which the remainder is over 45% of the estate. When the 45% test is not met, the executor may request an extension of time under Sec. 6161 for reasonable cause. The interest rate under this provision is the same as that under Sec. 6163 of present law.

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ELC

April 25, 1990

101ST CONGRESS
1ST SESSIONH. R. 1214
WITH AMENDMENT

IN THE HOUSE OF REPRESENTATIVES

introduced the following bill; which was referred to
the Committee on _____

A BILL

To amend the Internal Revenue Code of 1986 to provide a fixed
rate of interest on the postponed estate tax attributable to
a reversionary or remainder interest in property included in
the estate.

- 1 Be it enacted by the Senate and House of Representatives
- 2 of the United States of America in Congress assembled,

SECTION 1. RATE OF INTEREST ON ESTATE TAX ATTRIBUTABLE TO
REVERSIONARY OR REMAINDER INTERESTS IN PROPERTY.

(a) IN GENERAL. -- Section 6601 of the Internal Revenue Code of 1986 (relating to interest on underpayment, nonpayment, or extension of time for payment, of tax) is amended by redesignating subsection (k) as subsection (l) and by inserting after subsection (j) the following new subsection:

(k) RATE OF INTEREST ON PORTION OF ESTATE TAX POSTPONED UNDER SECTION 6163(A).--

(1) IN GENERAL.-- If the time for payment of an amount of tax imposed by chapter 11 is postponed as provided in section 6163(1), interest on the amount so postponed shall (in lieu of the annual rate provided by subsection (a)) be paid at the discount rate (and compounded annually) for the period of the postponement under section 6163(a).

(2) DISCOUNT RATE.-- For purposes of paragraph (1), the term discount rate means the rate used for purposes of chapter 11 to value the reversionary or remainder interest in property included in the gross estate.

(b) EFFECTIVE DATE.--

(1) IN GENERAL.-- The amendment made by this section shall apply to interest on taxes payable by estates in which the value of the reversionary or remainder interest in property included in the gross estate exceeds 45 percent of the value of the gross estate and the payment of which is

J

1 postponed until after October 6, 1986, under section 6163
2 of the Internal Revenue Code of 1986.

3 (2) EXCEPTION FOR INTEREST PAID.--The interest
4 required to be paid with respect to an estate tax
5 postponed under section 6163 of such Code after the
6 application of the amendment made by this section shall
7 not be less than the interest paid on or before October
8 6, 1986, with respect to the estate tax so postponed.

9 (3) EXCEPTION FOR INTEREST FOR PERIODS TO WHICH 4
10 PERCENT RATE APPLIED.--The amendment made by this section
11 shall not apply to interest for periods to which section
12 6601(b) of the Internal Revenue Code of 1954 applied (as
13 in effect before its repeal by Public Law 93-625).

14 SEC. 2. LIMITATION ON ESTATES ELIGIBLE TO POSTPONE PAYMENT OF
15 TAX BY REASON OF INCLUDIBLE REVERSIONARY OR
16 REMAINDER INTEREST.

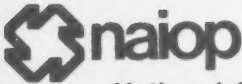
17 (a) GENERAL.--Subsection (a) of section 6163 of the
18 Internal Revenue Code of 1986 is amended--

19 (1) by striking "the gross estate," and inserting
20 "the gross estate and the value of such interests
21 exceeds 50 percent of the value of the gross estate,"
22 and

23 (2) by striking "such interest" and inserting
24 "such interests".

25 (b) EFFECTIVE DATE.--The amendment made by subsection (a)

- 1 shall apply to estates with respect to which an election is
- 2 made under section 6163(a) of the Internal Revenue Code of
- 3 1986 after the date of the enactment of this Act.



National Association of Industrial and Office Parks

1215 Jefferson Davis Highway • Suite 100 • Arlington, Virginia 22202-4302
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May 21, 1990

The Honorable Dan Rostenkowski
House Ways & Means Committee
Room 1102, Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The National Association of Industrial and Office Parks respectfully offers the following comment regarding the Discussion Draft on Section 2036(c) - Estate Freezes - as it relates to transfers with retained life estates.

NAIOP supports the repeal of Section 2036(c) without qualification.

Although said Section, together with many others of the Internal Revenue Code, seeks to protect against tax abuse, the ripple effect of this Section is the systemic destruction of small businesses (and in this instance, family-owned businesses) and entrepreneurial activity, forcing the businesses to either be ceded to larger companies or simply go out of business, to pay death taxes.

We believe that the effect of this Section is far more inimical to the societal and economic fabric of this country than any revenue that can possibly be generated by its existence.

The National Association of Industrial and Office Parks (NAIOP) represents over 7,500 professionals involved in developing, master planning, designing, constructing, financing and managing industrial and office properties. The Association's national headquarters are in Arlington, Virginia, (703) 979-3400.

Thank you for your consideration.

Sincerely,

Frank D. Visceglia
President

"Building Better Workplaces"

NFIB

National Federation of
Independent Business

SUBMITTED STATEMENT OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: House Ways and Means Committee
Subject: Effect of Section 2036(c) on Small Family Businesses
Date: April 24, 1990

The National Federation of Independent Business (NFIB) appreciates this opportunity to explain the problems small family businesses are having with section 2036(c) and to comment on the discussion draft released by this Committee to replace this law with more workable estate tax rules.

NFIB is the nation's largest small business advocacy organization, representing the interests of more than 570,000 small and independent business owners throughout the country. Our members appreciate the efforts of the Treasury Department and Members of this Committee who have made great efforts to address the problems created by section 2036(c).

ESTATE TAXES BEFORE SECTION 2036(c)

Section 2036(c) has exacerbated a problem faced by parents that have spent their lives building a family business that could be passed along to their children. Even before the arrival of section 2036(c), the owners of small family businesses were forced to sell off some or all of their assets upon the death of the parent for two reasons: (1) business assets are treated by the law as if they are liquid; and (2) the estate tax rate taxpayers must pay is too high, hitting a maximum of 55 percent.

Under current law, a business is valued when the owner dies, and the estate has to pay estate taxes on that value even if very few of the business's assets are liquid. If the business owns a building or a large amount of inventory, the taxes on these non-liquid assets can only be paid by selling part or all of the assets. Current law already recognizes the problems this creates for family farms, and allows the owners of family farms to value them on their "current" use instead of their "highest and best" use. This distinction allows farmers to avoid paying tax on their land as if it was used for development. Distinguishing between current and highest and best use is also allowed for closely held businesses, but there is usually little difference between the two and the protection from estate taxes small business owners receive from this rule is minimal. To better protect family businesses from devastating estate taxes, this Committee should consider legislating: (1) special valuation rules which would lower the value of family

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The Guardian of
Small Business

businesses that are passed on to the next generation (only if the next generation continues to operate the business); (2) special valuation rules which would lower the value of business assets that are passed onto the next generation in the form of a gift; or (3) an increase in the \$600,000 unified credit to \$2 million for family businesses that continue to be operated by the younger generation.

Small businesses are the engine that has pulled the American economy through the last decade of economic growth, and the entrepreneurial spirit of the founders of family businesses should not be undermined through unreasonable estate tax laws. Heirs of small business owners should not be forced to sell the family business to pay the estate taxes due when the owner dies. Current law does allow the heirs to pay the estate tax in installments spread over 14 years, but this saps the vitality of a company and endangers its future growth before the new management can get settled.

The estate tax rate is also a problem as long as family businesses are treated the same as other assets when valuing the estate. Lowering the estate tax rate would not only make it easier for small business owners to pass their business on to their children, it would reduce the search to find new and different ways to minimize estate taxes. A top rate of 55 percent creates a great incentive for estate planners to focus great attention on on paying as little tax as possible. Lowering the rate would not only help the survival of many small family businesses, it would reduce the amount of time, money and effort taxpayers would spend trying to minimize their estate taxes.

THE EFFECT OF SECTION 2036(c) ON SMALL BUSINESSES

Section 2036(c) has had a devastating impact on small family businesses. By threatening transactions that give a larger share of the future growth of the business to the younger generation, section 2036(c) strikes at the heart of parents' ability to pass small businesses onto their heirs.

Estate freezes are an extremely useful tool in preserving family owned businesses. They allow small business owners to pass along their live's work to their children, while still remaining involved in the business at some level.

Estate freezes allow the business owner to "freeze" the value of the business at the time that control over it passes to the next generation. In a typical estate freeze, the parent would perform a stock recapitalization and give the common stock to the children and keep the preferred stock. This would give the children an interest in the future growth of the business, and the parent would retain an income stream. Estate freezes help small family businesses smoothly transfer the operation of the business from one generation to the next.

There have been abuses of this practice in the past, but section 2036(c) did not stop at eliminating abusive estate freezes. Section 2036(c) applied to even arm's length transactions between family members. For example, even if a child that purchases the future growth of a parent's business for its fair market value, section 2036(c) still applies. It is the scope and reach of section 2036(c), not its purpose, that is most disturbing to small business owners.

Section 2036(c) carries a severe penalty -- appreciation in the value of the business that occurs during the parents' lifetime can be added back into their estate upon death. This is true even if most of that appreciation is not due to the work of the parent but to the work of the children.

Prior to section 2036(c), the children could avoid paying taxes on the increased value of the business that is attributable to their own hard work by doing an estate freeze and creating a point in time before which the value of the business is the parent's and after which any increase in the value of the business is the children's.

Example -- A parent owns a \$5 million business and wants to transfer control over it to a child. The child purchases control of the business for \$2 million and gains the right to future appreciation in the value of the business if it appreciates. In return, the child makes regular payments to the parent that corresponds to the \$3 million investment in the business. The child works seven-day weeks, and after 10 years the business is worth \$20 million. Under section 2036(c), much of the future appreciation, \$18 million, could be added into the parent's estate, even though that increase in value is due to the child's hard work.

The children of business owners should only have to pay estate tax on what they inherit from their parents.

Not only will section 2036(c) catch many business owners by surprise, they will not discover their mistakes until it is too late. The portion of the business that will be added back into the parent's estate is not determined until the parent's death. In other words, the heir could find out upon the death of the parent that the estate freeze the parent performed did not fall within 2036(c)'s confusing definition of a "freeze," and the increase in the value of the business could be subject to taxes as high as 55 percent.

Section 2036(c) is so complex and its effects so broad that NFIB wholeheartedly agrees with the first step taken by the discussion draft -- outright repeal. The compliance problems 2036(c) was designed to alleviate may be addressed in a number of different ways, but any solution to 2036(c) must begin with its repeal.

NFIB's basic concern with section 2036(c) is that it severely hampered the ability of a small business owner to pass along the family business -- in one piece -- to the next generation. If a substantial part of the business is subject to estate tax, some or all of the business will have to be sold to pay the tax. NFIB strongly believes

that family businesses have played a vital role in the economic development of our nation, and the tax code should not discourage the continuation of family businesses by hitting them with a tax so high that the business will have to be sold after the first generation.

REPLACEMENT OF SECTION 2036(c) -- THE "DISCUSSION DRAFT"

The discussion draft starts out on the right foot by repealing section 2036(c) and beginning anew. NFIB supports the discussion draft's basic approach of trying to value how much is transferred to the younger generation and not looking at who controls parts of the business. Focusing solely on valuation would greatly simplify current law. In addition, valuing what is transferred at the time of the transfer seems more equitable than waiting until the death of the parents to find out how much the children owe.

The discussion draft attempts to set up a system of rules that attempts to fairly value the business interest being transferred to the younger generation. The older generation would then have to pay gift taxes on the amount that interest exceeds the cap on tax-free gifts. NFIB agrees with this approach to correcting the problems with section 2036(c).

One of the primary troubles with section 2036(c) was that it attempted to solve a gift tax problem with an estate tax solution. Valuing interests in closely held businesses is difficult. Section 2036(c) did not even try to value the business at the time of the transfer, instead it waited until the older generation died before IRS looked back to determine the value of the business. The discussion draft's use of the gift tax to avoid abusive estate freezes is preferable to section 2036(c)'s use of the estate tax.

This gift tax solution, however, has some problems, and unless these problems are corrected NFIB will not be able to support this type of replacement for section 2036(c). Valuing a closely held business is not any easier than it was when section 2036(c) was drafted, and the discussion draft uses a number of valuation assumptions and monitoring requirements to ensure that the value of the business is approximately what the taxpayer says it is. NFIB is very concerned about how these valuation assumptions and monitoring requirements will affect small family businesses.

In addition, the discussion draft includes language that could lead to the same overly broad effect that plagued section 2036(c). The greatest concern NFIB members have with section 2036(c) is that it applies to everyday transactions between family members that are not intended to be an abusive avoidance of the estate tax system. For example, the discussion draft places rather severe limits on the use of buy-sell agreements. Buy-sell agreements between owners of a business and their children are a common method to transfer ownership of a business. Including restrictions on buy-sell agreements goes far beyond the scope of just trying to prevent abusive estate freezes. A replacement for section 2036(c) should focus only on eliminating abusive estate freezes.

Concerns with Valuation Methods and Monitoring Requirements in the Discussion Draft

The discussion draft contains the simple premise that when a parent transfers part of the business to a child nothing retained by the parent has any value except Qualified Fixed Payments (QFPs) and voting rights. The effect of this is to maximize the value of the business interest given to the younger generation and to maximize the amount of gift tax that will be owed.

* Limiting the Value of Qualified Fixed Payments

Qualified Fixed Payments (QFPs) are payments that are fixed as to amount, time of payment, and interest rate. This strict definition of a QFP ensures that the older generation will not undervalue what they transfer to their children by including in the deal a dividend to be paid by the children that is never paid. The problem with this definition of a QFP is that it is underinclusive. Too few rights in a business are given value under this definition. There are ownership rights that do have value on an open market that would be considered as having absolutely no value in calculating a QFP. For example, some developers that build shopping centers charge rent to the stores and also get a percentage of gross sales. On an open market, the right to receive a percentage of gross sales from a shopping center would have value. Yet, this right would not be a QFP and would have no value because it is not fixed. Similar problems arise with royalties. Lowering the value of a QFP lowers the value of the portion of the business retained by the parents, thereby increasing the value of what is transferred to the children and increasing the amount of gift tax that will be owed on this transaction.

* Valuation Premise

The discussion draft assumes that nothing can be deducted from the value of the business interest transferred to the children outside of an enumerated list of exceptions. This greatly increases the value of the children's interest in the business, and it may be the wrong approach. Small business owners who retain valuable rights in a business should not be penalized because what they retain is not on the list of what counts toward a QFP. A better approach may be to list what will not have value, and leave the assumption that rights retained by the older generation will have value unless stated otherwise.

Maximizing the value of the children's retained interest in the business may limit the attempts to abuse this area of the law, but it will also result in some very inequitable cases in which taxpayers are forced to pay too much in gift tax. The discussion draft's definition of QFP may value the interest transferred to the younger generation above its fair market value. This is a particular problem for small businesses that do not have the up front capital to pay the higher gift tax.

* No Legitimate Business Reasons for not Paying a QFP

If the younger generation fails to pay a QFP within three years, the discussion draft will consider that failure to pay to be a gift from the older generation to the younger generation, and it will be taxed as such. The purpose of this provision is to ensure that the parents are not giving the children gifts over time by not accepting the QFPs. The problem with the discussion draft approach is that it forces the younger generation to pay dividends to the older generation when, for legitimate business reasons, they should not do so. According to the discussion draft, the only way a business can skip a QFP and not have it taxed as a gift is if the business is insolvent or in bankruptcy. This requires businesses to make QFPs even if they are on the verge of insolvency. Requiring these payments not only makes little sense in a business context but it also may run counter to state corporate statutes, some of which prohibit corporations from making dividend payments if they are on the verge of insolvency. In addition, this requirement may require business owners to violate loan agreements they have with banks or suppliers that these creditors will be paid before others.

* The 20 Percent Requirement

The discussion draft also requires that at least 20 percent of the value of the business be reflected in the common stock when a business owner performs a stock recapitalization. Again, this increases the value of what is transferred to the younger generation. This requirement is also unnecessary because the other valuation rules in the discussion draft will ensure that the transfer is properly valued.

* Effect of the Valuation/Deemed Gift Rules

Taking together what the discussion draft does not consider to be a valuable right retained by the parent and the QFPs the parents must receive from their children, small businesses owners are going to face an increased gift tax when they transfer the family business to the next generation. If this Committee wants to continue to support family businesses, something will have to be done to assist small businesses in dealing with the increased gift taxes, either by changing the valuation rules for gifts of business assets to a family member or by allowing small business owners to pay the gift tax liability over a number of years. Current law allows closely held businesses to pay estate taxes over 14 years. Similar treatment of gift taxes would allow more family businesses to survive a transfer from one generation to the next.

Concerns with the Scope of the Discussion Draft

NFIB is most concerned about the type of transactions that will fall under the rules proposed by the discussion draft. For example, in the very first sentence of the discussion draft, it mentions regulating the transfer of interests in an "entity" and not the transfer of an interest in a business. The term "entity" could include a great deal more than just part of the family business.

In addition, the discussion draft also affects buy-sell agreements which are commonly used by family businesses. In a buy-sell agreement the parties agree to transfer the business for a set price at a point in the future. These agreements and rights of first refusal are usually reserved by a family that owns part of a business, and they want to keep that ownership within the family.

Buy-sell agreements are not in the same league as estate freezes, and either the discussion draft's application to buy-sell agreements should be modified or they should be dropped from the draft altogether.

Concerns with Confusing and/or Complicated Provisions of the Discussion Draft

In order for a payment to the older generation to be counted as a QFP, the discussion draft requires the consent of other family members who own stock in the business. This could create a problem if there are intrafamilial problems that extend beyond the ownership of the business.

The discussion draft extends the statute of limitations from three years to six years. NFIB sees no reason to break from the standard three year statute of limitations under these circumstances. Three years allows the IRS sufficient time to find and audit those attempting to abuse the system, and it limits the amount of time small business owners have to worry about being hit with unexpected gift tax liability.

The discussion draft fails to define a market rate of interest that should apply to the QFPs. This adds unneeded uncertainty to the already complex task of estate planning. The owners of family businesses need to know when they perform the estate freeze what the IRS will consider to be the market rate of interest in order to properly value the QFPs. If the market rate of interest is not defined, the IRS could establish a different and higher market rate than the parent doing the estate freeze and a heavy gift tax liability could result. The discussion draft should define an acceptable market rate of interest. An acceptable rate will not penalize businesses that traditionally have a low rate of return and cannot afford to pay the same rates as businesses with greater rates of return.

NFIB is also concerned that the valuation rules used for determining the gift tax due on the day of the freeze will not be the same rules used when determining the estate tax due when the owner of the business dies. The discussion draft does have some language indicating that items valued for gift tax purposes should be given the same value for estate tax purposes. This provision should be clarified so that taxpayers are not taxed twice.

CONCLUSION

In the search for something to replace section 2036(c), the discussion draft is a good first step. Several major problems with its approach to valuation and monitoring, however, have to be addressed before it will be acceptable to small family businesses. NFIB looks forward to working with the Committee to find a replacement for section 2036(c) that eliminates abusive estate freezes but still allows small businesses to survive the transfer of ownership from parents to children.

STATEMENT PREPARED BY THE COMMITTEE ON ESTATES AND TRUSTS
OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION
REGARDING THE MARCH 22, 1990 "DISCUSSION DRAFT" BILL
PROPOSING THE REPEAL OF SECTION 2036(c) AND THE
REPLACEMENT THEREOF BY A NEW CHAPTER 14

The Committee on Estates and Trusts of the New York State Bar Association Tax Section (the "Committee") is generally favorably impressed with the discussion draft of a bill to replace Section 2036(c) released by Chairman Rostenkowski on March 2, 1990, which it views as a more rational response to the "estate freeze" transfer tax avoidance problems Section 2036(c) of the Internal Revenue Code (the "Code") was intended to address. The Committee favors repeal of Section 2036(c). One of the Committee's principal objections to Section 2036(c) is its open transaction approach, which imposes deferred transfer tax consequences on donors based on the conduct of their donees. Moreover, because of its overly broad scope and complexity, Section 2036(c) discourages otherwise legitimate intra-family business transactions to an extent that outweighs any potential benefit to the integrity of the transfer tax system. The proposed Chapter 14 is, as Chairman Rostenkowski stated, "more focused" and "less burdensome" than Section 2036(c) because it corrects certain valuation abuses by means of a comprehensible and logical scheme the scope of which is generally readily determinable. The Committee applauds this more focused approach as an admirable step in the direction of tax simplification and would support enactment of the proposed legislation, subject to our concerns and proposed modifications discussed below. The Committee's concerns and suggestions regarding the intended scope and application of proposed Chapter 14 fall into the following categories:

1. Open Transaction Approach
2. Scope of Section 2701(a)
3. Transfers of Trust Interests
4. Buy-Sell Agreements
5. Clarifying and Technical Changes
6. Statute of Limitations
7. Effective Date

1. Open Transaction Approach.

The Committee is particularly concerned with the "open transaction" approach of Chapter 14 -- reminiscent of one of the most troubling features of Section 2036(c) -- which imposes additional transfer tax consequences on a donor even after the original transfer has been taxed pursuant to the special rules of Section 2701(a). Under Section 2701(a), only rights to certain "qualified fixed payments" ("QFP's") are accorded value when retained by a donor of a junior interest in an entity owned in part by the donor's family. Under Section 2701(c) and (d), the failure of such entity to make the scheduled payments in respect of the donor's retained interest and the disposition by the donor of his retained interest may each result in a deemed additional gift. The Committee opposes an approach to valuation that defers the final valuation of the transfer until some possibly remote time at which hindsight is invoked to create additional transfer tax consequences with respect to the original transfer. These deemed gift provisions introduce the potential for new uncertainties and difficulties of administration, some of which are discussed in Section 5 below, which undercut the benefits of the per se approach to valuation at the time of the original gift.

To the extent Section 2701 is intended to create certainty in the valuation of gifts at the time of the irrevocable transfer by the donor, we welcome such approach. Thus, we endorse the aspect of Section 2701 that imposes per se rules pursuant to which rights retained by the donor will be accorded value. Once these special rules have been applied, however, the Committee believes that finality is in order and that no further transfer tax should be imposed upon the subsequent failure of the subject entity to make the expected payments or upon the subsequent disposition of the retained interests. Existing gift and estate tax provisions adequately address the incomplete or revocable gift as well as the transfer with a retained interest. Therefore, where the gift of an interest in a family entity is a completed gift under traditional gift tax principles, the goal of Section 2701 should be a fair and equitable approach to valuation that neither gives the taxpayer too much credit for the retained interests nor subjects the taxpayer to a revaluation of the original transfer based upon subsequent events.

To the extent the deemed and additional gift provisions are thought necessary to correct for what may be unreasonably favorable assumptions with respect to the anticipated payment of QFP's, we recommend that the "favorable assumptions" set forth in Section 2701(a)(2)(B) be eliminated as a factor in the valuation of QFP rights. The principal concern that has driven Section 2036(c) and its proposed replacement is the risk that donors will refrain from exercising discretionary rights to which the valuation experts have accorded value. Under our approach, if retained rights were determined to be sufficiently

non-discretionary as to be accorded value for gift tax purposes, they would be valued under the traditional principles of valuation, without any special favorable assumptions. Accordingly, upon the later disposition of a QFP right, there would be no need to create an artificial additional gift to compensate for any excess benefit previously achieved by reason of such favorable assumptions. Instead, the likelihood of the payments being made would be factored into the original valuation. Similarly, as a payment right must be cumulative to qualify as a QFP, any missed payment should simply increase the value of the right in the hands of the donor, which value will ultimately be realized and/or subject to transfer tax upon its subsequent disposition by the donor during his lifetime or upon his death, except to the extent the entity is unable or unlikely to be able to make the payments. Under our proposal, the risk that the entity might not prosper would also be taken into account in valuing the original gift. Moreover, if the value of the retained QFP is less than its face amount at the time of the donor's disposition thereof (or death), the necessary corollary is that the junior equity interests will not have appreciated disproportionately.

We note in this connection that the draft provides no relief upon the subsequent gift or death time transfer of a retained QFP interest if such interest ultimately proves to have been worth more than its original valuation. This result is consistent with our proposal for a closed transaction approach to valuation of retained interests, but raises fairness issues if the open transaction approach, which gives only the government the benefit of hindsight, is retained.

To make our closed transaction proposal fully consistent and fair, the Committee would impose an additional restriction on the definition of a QFP by requiring, as under Section 2701(c)(2)(B), that the instrument under which the QFP is made must provide that a QFP not timely paid will bear interest compounded annually. Additionally, we would include a definition of "cumulative preferred stock" under which stock would not qualify as such unless it enjoyed a liquidation preference with respect to all unpaid cumulative dividends plus the compounded interest thereon. We would also eliminate, as inconsistent with the closed transaction approach, a transferor's ability under Section 2701(b)(4) to elect to have certain non-QFP's treated as QFP's.

Having endorsed the per se approach of the proposal, we would, nevertheless, add a provision whereby non-QFP rights, while presumptively valued at zero, could be accorded value if the taxpayer established such value by clear and convincing evidence. Many commentators have criticized the bright-line test of the statute as potentially ignoring rights that are not discretionary. Because it is impossible to compile a comprehensive list of additional rights that should or should not have value, we recommend implementing the per se rule, but allowing the taxpayer to rebut the statutory presumption by proving the value of non-QFP rights. A dramatic demonstration of the impossibility of compiling such a comprehensive list is Assistant Secretary of Treasury (Tax Policy) Kenneth W. Gideon's April 24, 1990 statement before the Committee on Ways and Means advocating the expansion of the permissible types of QFP's to include percentage leases and share-of-production royalty interests. Undoubtedly, after enactment, other interests will be identified which should have been included in the definition of QFP's or which, under certain circumstances, provide a high degree of certainty as to value. Allowing the taxpayer to establish such rights as worthy of being accorded value is a practical solution to this problem. To the extent dividends under such a right are noncumulative or non-interest-bearing or do not enjoy a liquidation preference, such factors will affect the value of such right. Similarly, in the case of preferred stock the dividend rights under which qualify as QFP's, a liquidation preference as to principal, while not itself a QFP, may be another attribute of value of such preferred stock. Of course, as under current law, the failure by the holder of a non-QFP that is accorded value to insist on his rights may constitute an additional taxable gift, depending on the particular facts and circumstances extant at the time of such failure. See, e.g., Snyder v. Commissioner, 93 T.C. 529 (11/2/89).

To aid in enforcement, we would require disclosure of transactions in which non-QFP's are accorded value if valuing such rights at zero would have resulted in, or increased the amount of, a taxable transfer. It may also be necessary to provide other enforcement tools to the government to deal with failures to insist on such rights. For example, a condition to according value to a non-QFP right might be a taxpayer's agreement to disclose any subsequent failure to receive payments under such right.

Although not directly related to our objections to the open transaction approach, we should note the potential under the draft for double taxation of a non-QFP right valued at zero under Section 2701(a) as to which the failure by the holder of such right to insist

on its enforcement may result in an additional taxable gift under the Snyder case. This anomalous result could be avoided by providing specifically in the bill that failure by the holder of such a right to insist on its enforcement will not be deemed to constitute an additional taxable gift.

A similarly harsh result occurs upon the subsequent gift (or transfer at death) of a retained non-QFP right valued at zero under Section 2701(a) in the original transfer. If a retained interest is valued at zero in connection with the initial gift, the transferor is effectively treated as having transferred not only the junior equity interest which is the subject of the gift, but also that portion of the retained interest which corresponds to the junior interest. Accordingly, no further transfer tax should be imposed upon the subsequent transfer of such portion of the donor's retained interest, inasmuch as the transferor has already been taxed on its value. This exoneration from transfer tax on the second transfer is necessary to avoid double taxation of the same property and is also consistent with the closed transaction approach which the Committee advocates.

This problem is recognized in Section 2701(e); however, the proposed relief upon such second transfer is far narrower than the Committee's recommendation. Section 2701(e) provides for an adjustment upon the subsequent gift (or transfer at death) of a retained non-QFP right valued at zero under Section 2701(a) in the original transfer, but does not necessarily eliminate the second gift nor does it reach back to alter the gift tax treatment of the closed original transfer. Rather, Section 2701(e) merely eliminates on a dollar for dollar basis any double counting for transfer tax purposes at the time of an actual subsequent gift or death time transfer of the non-QFP interest. If our proposal for the elimination of transfer tax on the second gift is not adopted, this minimum adjustment would remain appropriate and necessary under our closed transaction approach.

2. Scope of Chapter 14

The special valuation rules and corresponding deemed and additional gift concepts of Section 2701 come into play in the case of a transfer of an interest in an entity that is "10-percent owned" by the transferor and members of his family, regardless of whether such entity is closely-held or publicly traded. The Committee believes that the valuation abuses with which the government has been most concerned have primarily involved situations in which (i) family members or a small group acting in concert have control over the entity so that the shift in appreciation will inure primarily to their respective family members and (ii) the value of the transferred interests are not readily ascertainable. As a preliminary matter, the Committee views the inclusion of most publicly traded entities within the scope of the proposed legislation as unnecessary. If the transferred interest is actively traded publicly, there should be no risk of the valuation abuses sought to be corrected by Section 2036(c) and the discussion draft. Even if the value of the transferred interest is not actively traded publicly, valuation abuse is unlikely if the retained interest (or another interest in the entity comparable to the transferred or the retained interest) is actively publicly traded. Accordingly, the Committee would exclude transfers from the scope of Chapter 14 if either the transferred or retained interest (or a comparable interest) is actively publicly traded.

Even in the case of other entities, the Committee believes that the 10% test without more may cause Chapter 14 to apply to clearly non-abusive situations, especially in view of Section 2703(e)(1)(B), which treats siblings as family members for purposes of the 10% test. The inclusion of holdings by siblings for purposes of the 10% test may reduce this standard to a level of family ownership that is truly de minimus in many cases. Moreover, it has been the Committee's experience that the business and financial interests and goals of siblings are often independent of one another, particularly as siblings mature and have their own family interests. Although siblings may act together in a family enterprise in a manner to suit their common interests, their actions are frequently not more coordinated than those of unrelated business owners operating in a business context for their common good.

Accordingly, the Committee suggests that Chapter 14 not apply with respect to transfers of interests in an entity unless, in addition to the 10% test having been met, five or fewer individuals own more than 50% of such entity. For purposes of this "five or fewer test", the donor would be treated as owning all interests in the entity owned by members of his family, excluding siblings, and after taking into account the entity attribution rules in Section 2703(b). In the alternative, the Committee would recommend that the 10% test be replaced by a 51% test, using the expanded definition of family in Section 2703(e)(1)(B) and once again taking into account the entity attribution rules in Section

2703(b). Either of these alternatives would more appropriately target those situations with which the government has been traditionally and understandably concerned, i.e., those cases in which a relatively small group of individuals actually controls the entity, thereby possessing both the incentive and the opportunity for valuation manipulation.

3. Transfers of Trust Interests.

Various questions of construction arise under Section 2701 because it has only limited application to trust interests. Were the provisions dealing with trusts removed to a separate section, as the Committee recommends, some of the difficulties of construction would be solved. However, numerous serious problems will persist if transfers of trust interests are treated in all respects in a manner parallel to transfers of interests in corporations and partnerships.

The application of Section 2036(c) to trusts arose in the context of grantor retained income trusts. Section 2701 contains no such limitation. Thus, for example, the creation by a grantor of a trust in which his son has a non-QFP income interest for life, reversion to the grantor, could be interpreted under Section 2701 to result in the gift to the son being valued at 100% of the trust property. A similarly problematic result could obtain in the following example. Assume a trust created by a father in which his son has a non-QFP income interest for life followed by a non-QFP income interest in his grandson for life followed by a remainder interest in his grandchildren. If the son who is the first income beneficiary made a gift of his income interest to a family member, the value of the gift might, under the principles of Section 2701(a), be deemed to be the value of the entire trust property.* Equally troubling is the case of a trust providing for a non-QFP income interest for the grantor's son, remainder to the grantor's grandchildren. Under Section 2701, the gifts of each of the income interest and the remainder could be valued at 100% of the value of the trust, so that the sum of the gift tax values of the income and remainder interests could theoretically exceed (in this case by 100%) the value of the property transferred to the trust.

The Committee assumes that the foregoing results were not intended. In none of these examples was the creation of the trust interests subject to valuation abuse. Rather, each of the interests transferred would most rationally and reliably have been valued under the Treasury tables. Because the valuation abuses that were the target of Section 2036(c) occur only in the context of the grantor retained income trust, the Committee recommends limiting the application of Section 2701 to those trusts in which the grantor retains a term income interest. Such an approach would address in a more focused manner the abuse of trusts sought to be cured by Section 2036(c) and would avoid the inequitable results in the foregoing examples.

4. Options - Buy-Sell Agreements

A comprehensive body of case law has developed over the years respecting buy-sell agreements for purposes of fixing the estate tax value of a decedent's business holdings if certain requirements are met. Among the most important requirements, set forth in Treas. Reg. § 20.2031-2(h), are that the buy-sell agreement (i) be a bona fide business arrangement and (ii) not be a tax-avoidance testamentary device. The Committee recognizes that these guidelines have not been applied in a consistent manner, and that, as a result, the case law in this area has failed to establish a uniform interpretation of these requirements. However, the Committee believes that these guidelines are fair and reasonable and, when appropriately construed, should be adequate to prevent the use of buy-sell agreements as tax-avoidance devices.

In Section 2036(c) as originally enacted, buy-sell agreements were broadly indicted unless the purchase price formula produced a price representing fair market value at the time of the sale. In Notice 89-99, the Treasury in effect expanded the "safe harbor" under Section 2036(c) for buy-sell agreements to encompass an agreement containing a "formula, based on currently acceptable valuation techniques, that reasonably can be expected to produce a result that approximates the fair market value of the property as of the time the sale is consummated," provided such formula is "generally recognized as suitable to the

* Interestingly, under Section 2701(a)(2)(C), if the retained interest in a corporation or a partnership is junior or equivalent to the transferred interest, Section 2701(a) does not apply. However, this exemptive provision is specifically made inapplicable to trusts.

valuation of the type of property involved and acceptable in arm's-length negotiations taking place at the time the agreement is executed." (Emphasis added).

The discussion draft takes an even more restrictive approach than that taken in Notice 89-99. Under Section 2702, a buy-sell agreement will be disregarded in valuing the subject property unless (i) the property is in fact sold pursuant to the agreement and is not resold to an unrelated person within six months after the transferor's death or the date of the inter vivos transfer in question, (ii) the price formula was reviewed at least three years before the sale in question, and (iii) at the time of such review, the formula was reasonably expected to approximate the fair market value of the property at the time of such sale.

The Committee recognizes that a reasonably objective limitation on price formulae, such as that proposed in Notice 89-99, is consistent with the per se valuation rules of Section 2701 and may resolve certain of the inconsistencies among the judicial decisions in this area referred to above. Accordingly, while the Committee believes that it is not uncommon for a buy-sell agreement to set a low formula sales price for legitimate business reasons that are unrelated to donative intent, the Committee also recognizes that the certainty to be achieved by imposing such a limitation in connection with buy-sell agreements may outweigh the hardship in such cases.

Moreover, the Committee recognizes, as does existing case law, that periodic revaluation is advisable in the case of a buy-sell agreement using a fixed price. However, the Committee sees no justification for the three-year rule in the case of formula agreements. A formula that, at the time the agreement was entered into, was reasonably expected to reflect the fair market value on sale would by definition require that future appreciation or depreciation of the business be taken into account. Therefore, assuming all other regulatory and court imposed requirements were met, a buy-sell agreement containing such a formula should be respected for purposes of fixing the transfer tax value of a business interest without regard to when the formula was set or how recently it was reviewed. The imposition of a rule requiring periodic review thrusts the tax law unnecessarily into the negotiations among the parties (including parties who may not be family members) and may create a strategic imbalance among the contracting parties. This intrusion into the business relationships among the parties is not justified and should be dropped from Section 2702.

Finally, the Committee believes that the application of the restrictive rules of Section 2702 regarding buy-sell agreements should vary depending on the relationship between the transferor and the parties to the agreement. None of the restrictive rules should apply if non-family members have significant rights or options containing the same terms as those held by family members. If such persons participate to a meaningful extent in and are bound by the buy-sell arrangement in the first instance, no risk of estate planning abuse should exist. Similarly, if family members in the same or higher generation as the transferor, and no non-family members, have significant rights under the agreement that are equivalent to those of younger generation family members and if the older generation family members actually exercise such rights, the other restrictive rules should not be a prerequisite to permitting the formula value under the agreement to be considered for transfer tax purposes.

5. Clarifying and Technical Changes.

For ease of organization, our comments in this section are presented in the order they arise under the proposed statute, without regard to relative weight. Moreover, notwithstanding the strength of our objections to the open transaction approach and the three-year rule in the buy-sell context, our comments raise technical questions and suggest clarifications regarding certain of the provisions of the discussion draft containing those concepts.

a. Section 2701(a). The Bill should provide that in the case of the transfer of an interest in an entity which is convertible into an equity interest in such entity, the transferred interest will be deemed to be of the same class as such equity interest for purposes of determining both whether Section 2701(a) applies to the transfer and whether the transferred interest is a junior equity interest under Section 2701(b)(3).

b. Section 2701(a)(3)(B)(i). The definition of "junior equity interest" includes "in the case of a partnership, any partnership interest which is not preferential." Because of the flexibility in a partnership structure to create special allocations, we suggest that the bill define a junior equity interest in a partnership as "any partnership interest under which the rights as to income and capital are junior to the rights retained" by the transferor.

c. Section 2701(a)(4)(B). The exception for trusts holding only a personal residence should be amended to clarify that the interest held by a remainderman will not disqualify such a trust for the exception simply because the remainder interest is not a term interest. In addition, it would be helpful to have assurances that a power in the trustee (or life tenant) to sell the personal residence will not render the trust ineligible for this exemptive provision and that a subsequent sale by the trust of the residence does not trigger the application of Section 2701(a) at that time.

d. Section 2701(b)(1)(B). The definition of "qualified fixed payment" in Section 2701(b) treats payments as fixed as to amount or rate if such payments are "determined at a rate that bears a fixed relationship to a specified market interest rate." We assume that this provision is intended to include rates that bear a fixed relationship to the applicable Federal rates. If so, it would be helpful to clarify this point.

e. Section 2701(b)(3). Under Section 2701(b)(3)(B), a family member of the transferor who holds a QFP must consent to be treated as the transferor for purposes of the deemed and additional gift provisions if his interest is to be accorded value. Consistent with our objections to the open transaction approach discussed above, the Committee is concerned that this consent requirement may work inequities. For example, it may be impossible to obtain consent from an incapacitated or hostile family member, even though such family member is likely to insist on his rights under the QFP. If the open transaction approach is rejected, these problems disappear. If the open transaction approach is retained, relief should be provided in the case of such a non-consenting family member.

In addition, it should be clarified that in the case of a consent by a family member under Section 2701(b)(3)(B), all references to "transferor" contained in subsections (c) and (d) of Section 2701 will be deemed to refer to the consenting family member for purposes of applying these subsections in connection with the instrument held by such family member. The current draft language, while suggestive of this intention, is not entirely clear.

As a technical matter, Section 2701(b)(3) provides for two elections: (i) under subparagraph (A), the election by a transferor to treat payments that are QFP's as not QFP's and (ii) under subparagraph (B), the consent by a family member to be treated "in the same manner as the transferor" for purposes of subsections (c) and (d) of Section 2701. The draft provides no guidance as to the time and manner for making either election. While as a practical matter Section 7805(d) grants regulatory authority to the Secretary with respect to the time and manner of making tax elections, Section 2701(b)(4)(C) nevertheless provides that the election to have certain interests treated as QFP's is to be made on or before the due date (with extensions) for filing the gift tax return for the year of the transfer in question and (redundantly in view of Section 7805(d)) in the manner prescribed by the Secretary. The Committee questions the necessity for Section 2701(b)(4)(C) and finds its inclusion curious in light of the lack of specific guidance in connection with the elections under Section 2701(b)(3).

f. Section 2701(b)(4) and Section 2701(c). Section 2701(b)(4) permits a transferor to elect to treat certain non-QFP rights as QFP's. If such an election is made with respect to a noncumulative dividend, it is unclear how the deemed gift provision of Section 2701(c) would work in the event of a missed payment. If there is no surviving right to the missed payment, the three-year rule is meaningless. Similar concerns exist in the case of a partnership interest limited by the income or cash flow of the partnership. This area should be clarified in the bill.

g. Section 2701(c). Section 2701(c) contains the deemed gift rule which is operative in the case of a QFP not paid within three years of the date it was due. Section 2701(c)(2)(B) provides an exception to the deemed gift rule. This exception applies if the QFP is payable under an instrument providing that a QFP paid late is to bear interest "at a rate not less than the discount rate used in valuing" the QFP on the original transfer. The Committee questions the meaning of the reference to such "discount" rate, as well as the logic of using a date that looks back to a prevailing rate at the time of the original transfer. Looking back to the original Section 2701(a) transfer is particularly problematic if the underlying instrument predates the transfer. Using a rate prevailing at the time the QFP was due would more accurately reflect the economic reality of the benefit realized by the entity that failed to make the payment on a timely basis. Moreover, the Committee urges that a safe harbor rate be provided and suggests that a floating rate tied to the applicable Federal rates in effect on the date the QFP was due would be appropriate.

The Committee also believes that the taxpayer should be permitted a reduction in the value of the deemed gift to take into account ownership of a portion of the junior equity by non-family members. The hypothetical benefit to non-family members as a result of a missed payment does not constitute the kind of tax avoidance abuse Chapter 14 was intended to address. Although Section 2703(f)(1) contemplates that regulations will address this problem where the transferor is also a holder of junior equity interests, no such adjustment is contemplated where third parties hold such junior equity. Because we recognize the risk of reciprocal deemed gifts by multiple non-family members who hold preferred interests in the same entity, we would disallow this additional adjustment with respect to junior equity owned by third parties who themselves have family members holding preferred interests of the same or equivalent class as that held by the transferor.

h. Section 2701(d). Section 2701(d) contains the additional gift and additional estate asset provisions to which we object above. Were Section 2701(d) to be retained in any definitive legislation, we have the following observations:

In the case of a transfer of a right to receive QFP's, the transferor may be treated as having made an additional gift (or his estate may be deemed to include an additional phantom asset) under Section 2701(d). The bill should clarify the identity of the donee of this additional gift, which is not specified in the draft. The Committee assumes that this additional transfer would be deemed made to the original donee of the gift that was valued under Section 2701(a). However, we question this result where the original donee has transferred to a non-family member part or all of the property originally transferred before such subsequent transfer (or before the death of the transferor), and we suggest that in such case the additional gift (or estate asset) rules should not apply. Although it might be more logical to impose such additional tax when the donee disposes of the property, the Committee would object to this approach, which would even more closely resemble one of the most troubling aspects of Section 2036(c). In addition to the foregoing problems, transfers by the original donee may create generation-skipping transfer consequences under Section 2701(d) which are beyond the control of the original donor.

As noted above in connection with our discussion of the Section 2701(c) deemed gift, Section 2703(f)(i) provides that regulations will allow for adjustments in the application of Section 2701(c) and (d) in situations in which the transferor holds junior equity interests. However, in the case of the Section 2701(d) transfer, the Committee believes that the additional gift or estate asset should be further limited to a fraction of the amount calculated under Section 2701(d)(1) or (2) corresponding to the original gift of the junior equity interest. Thus, if a donor transferred 10% of the entity's common stock in the first transfer, the value of any additional gift upon the subsequent transfer by the donor of his retained QFP right should be only one-tenth of the total increment, if any, determined under Section 2701(d)(1).

The Committee is also concerned that use of the favorable assumptions in calculating the hypothetical value of the retained interest to determine the amount of the additional gift or estate tax under Section 2701(d), may result in a value that could in certain cases exceed the value of the underlying entity itself. This problem might be ameliorated by a provision that would cap the hypothetical favorable assumption value of the transferred preferred interest at no more than such interest's pro-rata share of 80% of the value of the entity, using an approach parallel to that used under Section 2701(a)(3) to establish the minimum value of junior equity.

In the case of the death of the transferor, the transferor's estate may be deemed to include an additional asset under Section 2701(d). The bill should address the allocation and source of the estate tax on such phantom asset. The recipient of such a phantom asset may not be a beneficiary of the residuary estate. Moreover, the transferor's estate may not be adequate to satisfy the estate tax liability on this phantom asset. In addition, the bill should specify that an additional asset will not be included in the transferor's estate under Section 2701(d)(2) if the entire value of the property originally transferred under Section 2701(a) is included in the transferor's estate under another section of the Code, such as Section 2036(a) or Section 2035.

Paragraph (5) of Section 2701(d) specifies that a termination of an interest is to be treated as a transfer. It is difficult to see how this concept would apply in the case of a trust interest. Unlike interests in corporations and partnerships which may be (and under Section 2701(a)(2)(B)(ii) are deemed to be) perpetual, trust interests are finite and their limited duration is a factor in their original valuation under Section 2701(a). Thus, the use of the Federal actuarial tables in originally valuing trust QFP's (the annuity or

unitrust interests permitted under Section 2701(b)(2)) is a sufficient safeguard against any valuation abuses sought to be corrected in Section 2701(d). Therefore, Section 2701(d)(5) should be made explicitly inapplicable to terminations of trust interests.

i. Section 2701(e). Section 2701(e) permits a reduction in the value of a subsequent gift of a retained right that was not treated as a QFP, to account for the right having been valued at zero under Section 2701(a)(2)(A) at the time of the original transfer. We have earlier suggested that this adjustment be replaced by a provision to the effect that the retained interest originally valued at zero under Section 2701(a) would also be valued at zero on its subsequent transfer.

As contained in the draft, the Section 2701(e) adjustment may not reduce the value of the subsequent gift below zero, so that no refund is available with respect to the gift tax paid on the original transfer. Moreover, no relief is provided if the retained right which was valued at zero at the time of the original transfer is later sold for value, with the proceeds thereafter constituting part of the donor's estate. If the open transaction approach of Section 2701 is abandoned as we advocate but Section 2701(e), as drafted, remains part of the statutory scheme, the failure to provide the additional types of relief described above can be rationalized. However, if the open transaction approach is retained, there is no reason that the taxpayer should benefit any less fully than the government from the hindsight approach. Thus, although permitting such subsequent adjustments would lead to even greater complexity and difficulties of enforcement and administration, such adjustments would be necessary to ensure evenhandedness in this area.

If the individual transferring the non-QFP right is a member of the transferor's family, such individual also receives the benefit of the Section 2701(e) adjustment. In that case, the reduction in value is to be determined "by reference to the actual transferor's increase in prior taxable gifts." The term "actual transferor" is confusing. While the Committee assumes the reference is intended to be to the original transferor, it could logically be interpreted to refer to the family member actually making the transfer giving rise to the Section 2701(e) adjustment. The bill should clarify that the Section 2701(e) adjustment is to be made in such a case with reference to the increase in the prior taxable gifts of the original transferor under Section 2701(a).

j. Section 2702. Under Section 2702, rights of first refusal and buy-sell obligations held by family members are generally to be ignored in valuing property for transfer tax purposes. As discussed above, however, it is not uncommon for such rights to be held simultaneously by both family and non-family members, in which case it would appear that Section 2702 could operate to cause inconsistent valuations of different fractional interests in the same property depending upon the identity of the holder of such rights. For example, if upon the death of a shareholder all the surviving shareholders, including non-family members, exercised their rights of first refusal to purchase a portion of the decedent's shares at a formula price, it appears that such price would be controlling for estate tax purposes only for the shares sold to non-family members. This problem would be eliminated by the Committee's proposal that none of the restrictive rules with respect to such rights apply if non-family members also hold such rights to a significant extent.

As discussed above, the Committee also opposes the three-year review rule under Section 2702 with respect to buy-sell agreements. Nevertheless, as a technical matter, if the three-year review rule is retained, the Committee notes that the three-year period is measured with respect to the sale in question. We believe that this is unfair in the case of a decedent. It may be impossible for the estate to effect a sale promptly so as to fall within the three-year period. Therefore, if the three-year rule is retained, in the case of a sale by reason of death the formula should be required to have been reviewed no more than three years before the decedent's death.

k. Section 2703 definitions. (A) Section 2703(a)(2). Section 2703(a)(2) treats a donee of a gift under Chapter 12 as a member of the transferor's family, thus automatically causing the Chapter 14 valuation rules to apply in all gift situations, regardless of whether they occur within the family. This provision not only means that Section 2701 is to be used in valuing all gifts of interests in 10% owned entities, but may also suggest that all such donees are thereafter to be treated as family members for purposes of both the 10% test and the determination of whether the retained interests held by such donees will be accorded value in the case of later gifts to family members. If so, as discussed above in connection with Section 2701(b)(3)(B), should the donor make later gifts to family members, the consent of such non-family members (who may have no interest in benefiting the donor's other donees and who may be unwilling to subject themselves to any potential tax liabilities

under the deemed and additional gift provisions) will be a prerequisite to according value to their retained interests. The Committee believes this result is unreasonable and has no relation to the estate freeze abuses sought to be curbed.

(B) Section 2703(b). Numerous clarifications are required under the entity attribution rules of Section 2703(b). For example, an individual should be treated as holding only his or her pro rata share of the right or interest in question, based on the extent of the individual's interest in the entity that actually holds the right or interest. Rules are also necessary to deal with cases in which an individual and/or his family members hold discretionary or contingent interests in a trust holding the right or interest. Approaches to some of these problems may already be found in the Code in provisions such as Section 318. To avoid further proliferation of attribution rules in the Code, we recommend that, wherever possible and reasonable, rules contained in existing provisions of the Code be adopted.

(C) Section 2703(d)(2). Under Section 2703(d)(2), a joint purchase is generally made subject to Section 2701. The transaction is treated as the acquisition of the entire property by the holder of the term interest followed by a transfer to other persons of remainder interests therein. Such treatment might be viewed as causing Section 2036(a) of the Code to apply in situations in which, in the absence of Section 2703(d)(2), it would be inapplicable. The Committee urges that a provision be included to the effect that no provision of Chapter 14 will cause Section 2036, or any other Code section, to apply to a transfer if such section would not otherwise apply.

The reference in Section 2703(d)(2) to the "person (or persons) acquiring the term interests" implies that a joint purchase involving the creation of successive term interests was contemplated as a transaction invoking this subsection. If all holders of term interests in a joint purchase situation are to be treated as transferors, the bill should clarify exactly how the provisions of Chapter 14 would operate as a practical matter.

1. Chapters 11, 12 and 13 cross-references. Proposed Chapter 14 superimposes a novel set of valuation and transfer tax rules upon the long-standing and familiar Federal estate and gift tax scheme contained in Chapters 11 and 12 of the Code. In addition, transfers subject to Chapter 14 may be generation-skipping transfers. It would be helpful to add cross-references in Chapters 11, 12 and 13 to the applicable provisions of Chapter 14.

m. Defined terms. The use in the draft of multiple defined terms for closely related concepts (and the placement in the draft of their definitions) as well as the use of multiple different expressions to refer to the same concept render the draft confusing and difficult to read. For instance, the words "right" and "interest" are at times used interchangeably, and the expression "specially valued fixed payment right" means a "right to receive qualified fixed payments" under a "specially valued retained interest". For simplicity and comprehensibility, the Committee recommends that a single term or expression be used to express each concept. Thus, for example, the bill could refer to (1) an "interest" in an entity to describe a donor's bundle of multiple "rights", some of which "rights" may constitute QFP rights, and (2) a "retained qualified fixed payment right" to refer to a "qualified fixed payment right" which has been retained in a transaction subject to Section 2701(a). Clarification of these definitions would also eliminate any ambiguity as to whether, in the case of a retained interest consisting in part of QFP rights and in part of one or more non-QFP rights valued at zero, the donor is eligible for some relief under Section 2701(e) at the time of a gift (or death time transfer) of the retained interest.

6. Statute of Limitations.

The discussion draft makes two major modifications in the statute of limitations under Section 6501 of the Code. The first change is to extend the three-year statute of limitations to six years with respect to a gift of property valued under Section 2701. The second change generally suspends the statute in the case of any gift valued under Section 2701 which is not reported.

The Committee questions the need for either of these changes. As to the suspension of the statute in the case of unreported Section 2701 gifts, it is difficult to see why the provisions of Section 6501(c)(1), (2) and (3) and Section 6501(e) would not be sufficient to give the Internal Revenue Service (the "IRS") adequate time to assess the gift tax. Section 6501(c)(1), (2) and (3) suspend the statute in the case of a false or fraudulent return, a "willful attempt to evade tax" and a failure to file a return, respectively, while Section 6501(e)(2) extends the statute to six years in the case of an omission of items on a

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gift or estate tax return which items in the aggregate exceed in value 25% of the total amount of gifts stated in the gift tax return or 25% of the gross estate as stated in the estate tax return.

The Committee recognizes both the government's legitimate concern in being timely and clearly apprised of estate freeze gifts and the historical difficulties in proving fraud or willful intent in omission cases in this area. Nevertheless, once the per se valuation rules of Chapter 14 are effective, the government's burden in demonstrating culpable intent in the case of an omission or substantial understatement, other than a failure to report an annual exclusion gift, should be greatly reduced.

The Committee is equally concerned with the extension of the statute from three to six years in all cases involving reported Section 2701 gifts. The proposed Chapter 14 provides a concrete, detailed scheme for valuing estate freeze gifts and, should the open transaction approach be retained, for identifying and valuing subsequent taxable events involving the retained property. Once this scheme is in place and a gift is valued and reported pursuant to such scheme, there should be no need to treat Chapter 14 gifts differently from any other taxable gifts, and the provisions of Section 6501(c) and (e) should be adequate to deal with Section 2701 gifts.

The Committee understands that the government's enforcement problems in this area have resulted primarily from situations in which the gift is not reported at all or is otherwise "buried" within other items in a manner that does not provide adequate disclosure. Again, because of the bright-line approach of Section 2701, the risk of good faith nondisclosure or undervaluation of gifts would be substantially eliminated. To our knowledge, there has been no showing (nor, indeed, even any allegation) that the IRS cannot ordinarily carry out its assessment and audit functions within the usual three-year period once it has proper notification of a taxable gift on a properly filed return. Given the concrete nature of the provisions of Section 2701, once adequate disclosure is made, no justification seems to exist for an extended period of limitations beyond the three-year period, which has met the IRS's requirements in virtually all areas of the tax law for many years.

To address any concern that Section 2701 gifts may be "buried" within the return or not reported because they fall within the annual exclusion and, thus, are not identifiable to the IRS as meriting attention, the Committee suggests imposing the requirement that all gifts, including annual exclusion gifts, and assets included in the gross estate, under Section 2701(a), (c) and (d), as well as any adjustment under Section 2701(e), be specifically identified as such on the return, and that a failure so to identify the gift would result in an extension of the statute to six years. The IRS would thus have adequate notice of the application of Section 2701, and all reported Section 2701 gifts disclosed as such would have the same three-year statute of limitations as all other gifts. Given the unambiguous nature of a Section 2701 gift, failure to report a Section 2701 gift as such could also be cited by the government as some evidence of the fraudulent or willful nature of an unreported or undervalued gift for purposes of the existing provisions under Section 6501(c) of the Code which have the effect of suspending the statute of limitations. As a technical point, it may be necessary to amend Section 6501(e)(2) to include within its scope transfers made under the new Chapter 14.

7. Effective Date.

The Committee recommends that the effective date of Chapter 14 be prospective, applying only to those transfers occurring after the date of enactment, but in no event earlier than the introduction of definitive legislation. Any pre-Chapter 14 "safe-harbor" transactions under Section 2036(c) should be grandfathered. In addition, we recommend a transition rule which would extend protection for a three year period with respect to existing buy-sell agreements.

Finally, in connection with the repeal of Section 2036(c), the Committee recommends that a provision be added, similar to Section 1433(c)(1) of the Tax Reform Act of 1986 with respect to the repeal of the former Chapter 13, to deal with refunds of gift and estate tax imposed pursuant to Section 2036(c).

STATEMENT OF JOHN J. O'NEIL AND EILEEN CAULFIELD SCHWAB
 NEW YORK STATE BAR ASSOCIATION
 TRUSTS AND ESTATES LAW SECTION
 COMMITTEE ON TAXATION

April 20, 1990

Discussion Draft, dated March 22, 1990, of proposed legislation to repeal Internal Revenue Code § 2036(c) and to add a new Chapter 14 relating to special valuation rules in cases of transfers of interests in ten percent owned entities to family members.

REPORT PREPARED BY THE COMMITTEE ON TAXATION OF THE TRUSTS AND ESTATES LAW SECTION.

The discussion draft, if enacted, would repeal Internal Revenue Code Section 2036(c) retroactively to December 17, 1987, its effective date, and would replace it with a new Chapter 14 entitled "Special Valuation Rules." Proposed Chapter 14 is intended to address in a narrower and more coherent fashion the perceived abuses sought to be alleviated by the enactment of the present Section 2036(c) -- stated to be the undervaluation for gift tax purposes of property transferred to family members (usually those in a younger generation), through the retention of overvalued retained rights, which, in a family context, are unlikely to be exercised. The approach of Section 2036(c) is to treat retained rights in an enterprise as a retention, for purposes of Section 2036(a), of the use or enjoyment of the property transferred to the younger generation, causing inclusion of the date of death value of such property in the transferor's gross estate. The Section is triggered if a person who holds a substantial interest in an enterprise, (i) "in effect" transfers property having a disproportionately large share of the potential appreciation in such enterprise, while (ii) retaining an interest in the income of or rights in the enterprise. If the transfer falls within the scope of Section 2036(c) and the transferor holds the retained interest at death, the date of death value of the transferred property will be included in the transferor's gross estate. If before the transferor dies, he or she transfers the retained interest, or the retained interest terminates or lapses (e.g., the term of a note expires), or the transferee transfers the originally transferred property, the event will be treated as a "gift" by the original transferor, and a gift tax will be imposed on the fair market value of the originally transferred property at the time of the "gift".

Transactions among family members are particularly suspect because, although Section 2036(a) specifically exempts bona fide sales for full and adequate consideration from the scope of the section, this exception does not apply to sales to members of the transferor's family, defined to include the transferor's spouse, lineal descendants of the transferor or the transferor's spouse, the transferor's parents or grandparents and any spouse of the foregoing.

Because of the potential application of Section 2036(c) to family transactions not intended to avoid the estate tax, the Technical and Miscellaneous Revenue Act of 1988 excepted from the scope of the statute certain loan, employment, sale and trust arrangements that meet specified statutory requirements. On August 31, 1989, the Internal Revenue Service issued Advance Notice 89-99 (the "Notice"), intended to provide guidance under Section 2036(c), including an explication of the statutory safe harbors.

Proposed Chapter 14 departs from the estate tax inclusion approach of Section 2036(c), and provides rules for the valuation of retained interests at the time of transfer for gift tax purposes with respect to family transactions. The Committee is in favor of this approach.

Like Section 2036(c), Chapter 14 would apply only where the transferor transferred an interest in a "10 percent owned entity," specifically defined to include corporations, partnerships and trusts. This is an improvement over the ambiguous use of the term "enterprise" in Section 2036(c), defined in the Notice to mean any undertaking or venture, ordinarily for profit. The definition of family would remain the same, and family attribution rules likewise would apply in determining whether the transferor owned a 10 percent interest in the entity.

If Chapter 14 is triggered, for purposes of determining the value of the gift of the transferred interest, the value of any retained interest which is not a right to receive a "qualified fixed payment" ("QFP") or is not a specifically exempt retained interest would be treated as being zero. Qualified fixed payments and exempt retained interests would be valued in accordance with present law, with one important caveat. In the case of transfers of interests in corporations and partnerships, the valuation of a qualified fixed payment may not reduce the value of the transferred interest (i.e., the common stock) below its proportionate share of 20 percent of the total equity interests in the entity.

With respect to corporations and partnerships, QFP's are defined as dividends payable on a periodic basis from any cumulative preferred stock, if determined at a fixed rate or tied to a specified market interest rate, or any other payment or distribution fixed as to both amount (which may be tied to a specified market interest rate) and time of payment. In the case of trusts, QFP's are generally defined as (i) any fixed amount payable not less frequently than annually (i.e., an annuity trust), (ii) any amount payable not less frequently than annually which is a fixed percentage of the fair market value of the principal (determined annually) (i.e., a unitrust) and (iii) a noncontingent remainder interest if all of the other interests in the trust consist of qualified fixed payments. Under certain circumstances, the transferor may elect to treat certain retained interests as qualified fixed payments, providing flexibility in structuring transactions.

Exempt retained interests would include interests of the same class as the transferred interest, voting rights and junior equity interests. (This provision would not apply to trusts, although, clearly if the trust contained shares of a corporation or partnership interests, the draft should be so amended.)

If a qualified fixed payment is not paid within applicable grace periods, the transferor would be treated as having made a gift of the unpaid amount.

The proposed draft includes rules applicable to the subsequent transfer of the retained interest designed to avoid double taxation. Special relief provisions apply in cases of transfers or discharges of retained interests during insolvency or bankruptcy.

Especially with respect to common business transactions between family members, proposed Chapter 14 is more closely tailored to the valuation abuses Section 2036(c) was designed to combat. For instance, employment agreements, initially within the scope of a literal reading of Section 2036(c) thus necessitating the enactment of a safe harbor, would not fall within the scope of the proposed

draft. Moreover, unlike Section 2036(c), proposed Chapter 14 defines the transferor's rights and obligations at the time of the transfer, allowing him or her to quantify the gift tax liability. Under Section 2036(c) the transferor may never know with certainty the extent to which the transferred property may appreciate, and accordingly, what his or her estate tax (or subsequent gift tax) liability may be. In addition, Section 2036(c) would in many cases require a determination at death of whether a transferor transferred a disproportionate share of appreciation in a transaction possibly occurring many years before, raising problems of the availability of necessary proof. Accordingly, proposed Chapter 14 appears to take the better approach.

The application of proposed Chapter 14 to trusts appears, in some respects, to be more restrictive than under present Section 2036(c). For example, the draft restricts the use of grantor retained income trusts ("GRITs") because the retention of an income interest for a fixed term would not qualify as a QFP and accordingly would be valued at zero. In addition, the grantor would not be permitted to retain a contingent reversion should he or she die before the trust term to further deflate the value of the remainder. The statutory GRIT exception added to Section 2036(c) in 1988 represented a then legislative determination to exempt such trusts from the scope of the statute and should be incorporated into the proposed draft.

The personal property use exemption to Section 2036(c) set forth in the IRS Notice should also be incorporated into the draft, which at present only provides a narrow exception for trusts containing a personal residence. If a trust contains tangible personal property, the grantor's retained interest would be valued based on the amount such interest could be sold to an unrelated third party.

Clarification should be made on the applicability of Chapter 14 to charitable lead trusts and charitable remainder-trusts where an interest is retained by the grantor.

Because proposed Chapter 14 had apparently abandoned the spousal unity rule of Section 2036(c), insurance trusts appear to be exempt from its scope.

Finally, proposed Chapter 14 would unnecessarily tighten the rules governing the valuation of property subject to options and buy-sell agreements by providing that any right of first refusal or option shall be disregarded in valuing such property unless (i) the right or option is actually exercised, (ii) the price at which the property is sold is determined pursuant to a formula which was reviewed no more than three years before such sale, and (iii) at the time of such review, the formula was reasonably expected to produce a price approximating fair market value at the time of the exercise. Only requirement (iii) appears to apply to such rights under present Section 2036(c). In addition, with respect to buy-sell agreements, a provision should be added to grandfather such agreements or options already in existence on the effective date.

For the reasons stated above, it is believed that proposed Chapter 14 is an improved and reasonable approach particularly with respect to transfers of interests in corporations and partnerships, but should be modified to remain consistent with the legislative concerns that prompted enactment of the safe harbors now found in Section 2036(c).

Person who prepared the report: John J. O'Neil, Esq.
Chair of the Committee: Eileen Caulfield Schwab, Esq.



NORTH AMERICAN EQUIPMENT DEALERS ASSOCIATION

Serving Farm, Industrial and Outdoor Power Dealers



STATEMENT OF THE NORTH AMERICAN EQUIPMENT DEALERS ASSOCIATION BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS ON INTERNAL REVENUE CODE SECTION 2036(C)

Mr. Chairman, I am William E. Galbraith, Executive Vice President of the North American Equipment Dealers Association (NAEDA). NAEDA represents over 7,000 farm and outdoor power equipment dealers throughout the United States. They are located in every state and provide the equipment and service necessary to maintain the productivity of our nation's farmers. NAEDA's dealerships are small businesses but are often among the largest employers in their communities. On behalf of those dealers, I am pleased to comment on Section 2036(c).

NAEDA's members are extremely concerned about the impact of Section 2036(c) on themselves, on their families and on their communities. As we understand it, Section 2036(c) was intended to protect against abuses in estate planning. In fact, in its current form, it goes well beyond stemming abuses and prohibits what we believe to be are legitimate practices aimed at keeping businesses healthy and intact.

Many of our members are operating family businesses which have been passed down through several generations. The farm equipment business has not been an easy one, particularly in recent years, and a number of dealers have been forced out of the marketplace. Those who remain are committed to the industry, to the community and to passing on a way of life to their children. These are true family businesses with the husband, wife, and children working long hours alongside their employees to make the business succeed. That success is based upon good will and years of dedicated service to their customers.

It is only logical that parents want to pass on the business to their children who have helped build it. Unfortunately, Section 2036(c) severely restricts their ability to do so. The imposition of estate taxes as high as 55% can effectively sound the death knell for the business.

The majority of our dealers have virtually all of their assets tied up in the business--both in the buildings and the inventory. Passing on the business is not the same as passing on cash. There is not the liquidity available to pay large estate taxes. Even if the heirs want to, it may be difficult to obtain loans to pay off an estate tax debt. As a result, in its application, Section 2036(c) can easily result in the heirs having to liquidate the business in order to pay the tax. The business is lost, jobs are lost, and the local source of farm equipment and service is lost.

It seems to us that Congress, while protecting against abuses, should actively promote the development and continuity of family businesses. During difficult times, it is often a combination of the experience of growing up in the business and the pride of carrying on the family tradition that keeps the business going. Forcing families to sell off the business to strangers (if buyers can even be found) who do not have the same experience or commitment does not serve any worthwhile public purpose. On the other hand, if the business is sold to another dealer who combines it with his own, another business is lost. In rural America every business lost is another nail in the coffin of many of our rural communities.

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Mr. Chairman, NAEDA commends you and the Committee for holding a hearing on this critical issue and for your willingness to consider the problems caused by Section 2036(c). NAEDA would prefer total repeal of Section 2036(c) which is the subject of legislation introduced by Congressman Archer, Senator Symms, and others. Short of that, we encourage Congress to adopt corrective legislation narrowly drafted to target real abuses and to protect the legitimate practices of family-owned businesses. We are, however, very concerned that the discussion draft is too complex and, like the current Section 2036(c), is too broad--encompassing practices which clearly are not abusive.

A number of practitioners and business organizations have provided the Committee with extensive and technical comments on the discussion draft. I believe that they are, for the most part, well-reasoned and are offered in the spirit of trying to help the Committee and Congress correct the problems caused by Section 2036(c). I urge the Committee to carefully review those comments in crafting legislation in order to ensure that any revision to Section 2036(c) will protect, not weaken, family businesses in America.

Lane Powell Moss & Miller

MEMORANDUM

TO: Robert J. Leonard
FROM: Ellen O. Pfaff
DATE: May 4, 1990
RE: Discussion Draft Replacement to Section 2036(c)

Section 2036(c) has been both a nightmare and a paradise for attorneys and accountants. It has only been a nightmare for the owners of small businesses. For this reason, the public would be best served by the retroactive repeal of Section 2036(c). The public will not be well served if any replacement to that section is over broad and complex. The public's frustration with successive unworkable legislation can best be avoided by adopting an alternative that is simple and reasonable, both in terms of correcting past abuses and in terms of allowing small business to remain family owned. Below are a list of points which I believe merit attention prior to enactment of any replacement to Section 2036(c).

1. The Discussion Draft is much too complex and will serve to raise the same outcries from the public as did Section 2036(c) because businesses will incur unnecessary professional fees in trying to interpret the statute. I am enclosing a outline from a seminar which I recently attended prepared by a knowledgeable legal practitioner. He poses questions and problems with the Draft Discussion. This is just the tip of the iceberg, but it does give you some idea of how the complexity of the Discussion Draft parallels that in Section 2036(c).

2. The "abuses" which initially gave rise to Section 2036(c) were "freezes" in value through corporate recapitalizations and partnership freezes. I hope any replacement legislation will limit its scope to address this problem by requiring that transfers in a traditional recapitalization or partnership freezes are appropriately valued. This Discussion Draft is over broad in two ways.

a. While the Discussion Draft is preferable to Section 2036(c) in that any post-transfer appreciation is not subject to tax, it instead creates an appraiser's dream. Families often makes gifts on an annual basis to children and grandchildren. Congress has enacted a \$10,000 per year annual exclusion to accommodate this practice. Under the Discussion Draft if gifts of common stock were made annually when there are preferred interests outstanding, an appraiser would have to revalue the preferred and common shares using the subtraction method. Thus over a period of years when families were making annual gifts to their children and grandchildren, there would be a variety of different values for preferred stock and theoretically for common stock, none of which may have any relationship to market value. The alternative to Section 2036(c) should be limited to cover only the initial freeze transaction.

b. In addition to being over broad in its coverage of the freeze technique, the Discussion Draft is over broad in that it covers extraneous transactions such as leases, recapitalizations, redemptions and trusts. The Chairman's comments introducing the Discussion Draft state that it does not cover employment agreements, but I cannot find in the statute where they are exempted. Congress will go a long way in relieving itself of future problems with this legislation if it strips away these extraneous transactions from this legislation. If there are abuses from the use of these other transactions, then they should be covered in separate legislation where they can be dealt with thoroughly and thoughtfully. To include them in the Discussion Draft without such thoroughness and thoughtfulness will only create public uproar again and require technical corrections or repeal.

3. The following is a list of some specific concerns with the Discussion Draft. It is not inclusive.

a. The Discussion Draft apparently has tried to prevent discrimination against family-owned, closely-held businesses by including non-family member donees under the definition of "family" in proposed Section 2703(a)(2). This will only result in increased complexity, especially if a

series of business transactions within an entity occur.

b. There are some problems with qualified fixed payments that need to be considered. What is "specified market interest rate?" It could be as high as 20% even in the present economic climate. Few corporations could pay such a rate, and the new "game" may be to give the retained interest to younger generations. What happens if there is a non-payment of a qualified fixed payment for four years with additional gifts assessed, and then the dividends are actually paid? Is there a refund of the gift tax paid? If you sell for less than the qualified fixed payment regardless of the market value, is there an additional gift? Is it reasonable to require the consent of the other preferred shareholders to treat payments as qualified fixed payments? What happens when there are family feuds?

c. If redemptions are included within the umbrella of this replacement legislation as contemplated under Section 2703(c), then shouldn't redemptions under Income Tax Code Section 303 which allow redemption of stock to pay death taxes be exempt?

d. Section 2702 on options and buy-sell agreements apparently provides that such restrictive agreements will not impact value except where there is a sale under the terms of the agreement and where the price has been reviewed within the last three years and at the time of review was reasonably expected to produce a price which would approximate the fair market value of such property at the time of such sale. This means that restrictive agreements could not have an impact on gifts and transfers by Will. This fails to recognize the importance of such agreements in protecting and providing for the transfer of family business from one generation to another.

e. The new regime is applicable to transfer of an interest in a 10-percent-owned entity to a family member.

(1) Interest - the term "interest" is inadequately defined. The following items could be

interpreted to be "interests."

- (a) Equity, debt and leases.
- (b) Compensation arrangements.
- (c) Royalty and similar rights.

(2) Entity. Although the statute clearly includes corporations, partnerships and trusts, it does not stop there. The statute provides that the transfer of any interest in property in which there is a life estate or any interest in property for a term of years will be considered to be a transfer of an interest in trust. Thus the term trust includes any transaction in which the donor transfers property but retains a life estate or term of years interest. Does "entity" include purchase and sale agreements which are on the installment basis?

f. The mandatory valuation of the retained interest ("qualified fixed payments") seems workable with reference to preferred stock (i.e., any dividend must be fixed, preferred and cumulative) but is unclear when applied to partnership interests or trusts (i.e., when will a right to a payment under an interest in a partnership be fixed both as to amount and time). The treatment of qualified fixed payments ignores whether the entity itself can bear the burden demanded by the payment schedule. What if the entity wants to finance a new expenditure?

g. If QFPs are not paid over a three-year stretch, the original transferee is deemed to make a taxable gift. There are exceptions for corporations which are insolvent or if the QFPs bear adequate interest but these exceptions are not helpful when the corporation is prevented from paying QFPs because of inadequate cash flow. The payment of QFPs places an inordinate burden (which would undoubtedly allow such businesses to meet the insolvency exception) on the cash flow of closely held businesses.

**A BRIEF COMPARISON OF CHAPTER 14 WITH IRC §2036(c)
AND AN EXAMINATION OF CERTAIN TECHNICAL FLAWS AND
SUBSTANTIVE PROBLEMS OF CHAPTER 14**

I. Favorable Aspects of Proposed Chapter 14 in Comparison with IRC §2036(c)

A. In general, Chapter 14 has a more sound attack on where the estate freeze abuses lie (there were valuation abuses). Under Chapter 11 and Chapter 12, a freeze can always be effectuated by an outright gift of the whole "enterprise". Chapter 14 recognizes this "freeze" theory of Chapter 11 and Chapter 12, while IRC §2036(c) did not (which resulted in extremely unfair results).

B. Post-transfer appreciation is not taxed under Chapter 14. Thus, the unfair consequences of assessing both an initial gift tax and an estate tax under the "Hard to Complete" theory of IRC §2036(c) is eliminated by Chapter 14.

C. The taxation of post-transfer appreciation for gift tax purposes which exists under IRC §2036(c)(4) is also eliminated.

D. Meeting the requirements of qualified fixed payments ("QFP") appears to be simpler than meeting the safe harbor requirements under IRC §2036(c)(7).

E. Other difficult safe harbor requirements for start-up enterprises are avoided, assuming the QFP regime can be satisfied.

F. Assuming the QFP regime can be satisfied, transactions such as leases and installment sales are not subject to transfer taxation under Chapter 14, while they could be under IRC §2036(c).

G. Assuming the QFP regime can be satisfied, there is greater certainty under Chapter 14 as to the result than existed under IRC §2036(c) because of the many nuances and interpretation issues associated with IRC §2036(c).

H. Gifts of senior classes of equity interest of a business are not subject to Chapter 14, while under certain circumstances gifts of senior classes of equity interest may have been subject to IRC §2036(c). Thus, a reverse freeze is possible.

II. Substantive Problems with the Scope of Chapter 14 (IRC §2703)

A. Because a person's family also includes any transferee for purposes of Chapter 12 (see IRC §2703A(2)), Chapter 14 will apply to certain corporations which are not closely held. For example, consider the applicability of Chapter 14 if a recapitalization occurs (a recapitalization is certainly not in the ordinary course of business) and the preferred stock is not equal to the value of the common stock for which it is exchanged. Even if the gift is a small gift, the consequences to the transferee and the transferor will be much greater than any gift tax consequences under Chapter 12, because the deemed gift rules and QFP rules of Chapter 14 will then apply.

B. Entity is defined to include corporations, partnerships and trusts (see IRC §2703(e)(1)). Trust is defined very broadly under IRC §2703(d)(1):

For purposes of this Chapter, the transfer of an interest in property with respect to which there is one or more term interests shall be treated as a transfer of an interest in a trust.

Does the term "entity" include virtually any transaction involving investment and personal use property? If I transfer mineral interests, subject to a royalty, to my son or I transfer to my daughter a building subject to a lease to me, are those transactions considered trusts and, thus, "entities" for purposes of Chapter 14?

C. The term "interest" is inadequately defined. It clearly includes equity, debt and leases (see IRC §2703(e)(3)). The following arrangements could be interpreted to be an "interest" for purposes of Chapter 14:

1. Compensation arrangements which do not qualify as QFP's because they are subject to percentage bonus arrangements which terminate on the death of the holder of the compensation arrangement.
2. Any type of royalty or patent copyright or mineral.
3. Any type of lease which is subject to being paid as a percentage of gross sales.
4. Certain non-compete agreements.
5. Any arrangement in which a return of or is a product of the gross sales or production unit measuring base.
6. Any loan which does not qualify as a QFP. For example, demand loans and open account loans do not appear to meet the definitional requirements of QFP due to the lack of a fixed payment date.
7. Several automatic rights which should have value do not have value for purposes of Chapter 14. For example, automatic call, automatic convertibility, automatic redemption and automatic liquidation rights do not have value for purposes of Chapter 14.

III. Technical and Substantive Concerns of §2701

A. IRC §2701(a)(1) articulates the value of what the transferor has retained but does not give guidelines as to the value of what the transferee receives. For instance, assume our transferee receives only 15% of the voting stock of a corporation. Let us also assume that the transferee is deemed to have received, under the IRC §2701 rules, 70% of the value of that corporation. Are marketability and minority discounts to be applied to that 70% interest (i.e., the stock would be valued as if it was a 70% interest in non-voting stock of the corporation)? Or is the transferee's interest for gift tax purposes equal to 70% of the value of the corporation without any discounts?

B. Are routine limited partnerships where all of the allocations are pro rata exempted from coverage under Chapter 14? The statute does not apply to transferred interests which are identical to retained interests except for voting rights. See IRC §2701(a)(2)(C)(ii). In addition to differences to management rights, limited partners are generally not jointly and severally liable for partnership debts, which is not the case for a general partnership interest. Is this interest (which is a substantive economic difference) enough to bring in all limited partnerships under coverage of Chapter 14?

C. The statute provides no guidance as to the valuation of QFP's. Chairman Rostenkowski's summary indicates valuation is determined by reference to "appropriate market discount rates". What is an appropriate market discount rate if it is to be assumed that the QFP is always to be paid? Is the market discount rate better than Treasury's rate? Or for purposes of determining the appropriate market discount rate do you look at dividend coverages and other factors which would affect the market discount rate? If so, how does this interpretation square with the professed goal of Chapter 14 that difficult valuation matters such as dividend coverages will not have to be studied by the taxpayer or the Internal Revenue Service? If market rates of return have to be examined, in light of the collapse of the junk bond market for publicly traded corporations, what is an appropriate discount rate for fixed income securities in a closely held business? Is there any business in which a discount rate of less than 20% can be justified?

D. All interests held by family members of the transferor would be valued at zero unless the interest qualifies as QFP's and such members elect QFP treatment (see IRC §2701(b)(3)(B)). Many technical and substantive problems exist with this "system":

1. IRC §2701(b)(3)(B) uses the term "instrument". Is this the same as "interest"? The statute seems to interchangeably use the term "rights", "interest" and "instrument". One assumes these may mean different things. Or perhaps one should assume that different people drafted different parts of the statute.

2. The consent requirement assumes cooperative families. No comment need be made about that assumption.

3. The statute assumes interest will always be held by competent individuals or will never be held by fiduciaries. Query, what guardian ad litem or trustee would ever approve an election into Chapter 14 with its deemed gift rules?

4. The ability to pay the transfer tax under Chapter 14 is endangered by this Section. For example, assume that the major asset of a transferor's estate is his interest in a closely held corporation. He transfers all of his common stock in that corporation (which represents 15% of the common stock of that corporation) to his daughter. He retains a compensation arrangement which is subject to the gross sales of the corporation. The preferred owners of the corporation (who are family members and have 55% ownership) refuse to elect into the system. As a consequence, the transferee (the son) is deemed to own 70% of the value of the corporation. Neither the transferor, nor the transferee, have the ability to pay the transfer taxes associated with that transaction. Who pays the tax? Is it possible for a transferee, under this system, to receive a gift for which the transferee will be liable, which is not equal to the value of the assets that the transferee received in the gift? The answer appears to be clearly yes!

5. These consent provisions clearly appear to be a trap for the unwary. What if there is a late consent?

6. Do nominal transfers of annual exclusion amounts suddenly become huge gifts? If so, will the effect of Chapter 14 be to stop all lifetime transfers of so-called "interests" in so-called "entities"?

7. If family members elect into this system, who is the recipient of the gift if the QFP amounts are not paid?

E. Under IRC §2701(c)(2)(B) the deemed gift rules may be avoided if compound interest is paid at the discount rate used in valuing the QFP. As noted above, the determination of what that market rate is doubtful. If the market rate is a high rate of return, and the compounding must be done at that high rate of return, then this "out" from the deemed gift rules is meaningless. No business can afford to pay a 20% compound rate of return. Also, it appears that the compound rate of return "out" from the deemed gift rules for failure to pay the QFP's is not available if compound interest is paid, but paid at any rate (no matter how small) below the deemed market rate.

F. Many issues arise under the gift tax refund provisions of IRC §2701(c)(3):

1. The generation-skipping tax exemption used and the generation-skipping tax paid appear to be forgotten. Is there to be any refund for these taxes and/or exemption?

2. What happens if a QFP is paid to an heir of a deemed transferor? Is the heir allowed to apply for a gift tax refund?

3. What happens if a spouse elects gift-splitting with respect to the deemed gift from nonpayment of a QFP? The statute seems to fail to provide

for the restoration of the spouse's unified credit, adjusted taxable gift, generation-skipping tax exemption and generation-skipping tax.

G. IRC §2701(c)(5) attempts to equalize or avoid the double tax associated with deemed gifts for delinquent QFPs. However, the double tax or lack of equalization appears possible in many common events:

1. There does not seem to be a coordination under the income with respect to the decedent income tax provisions. Should a missed QFP qualify as income with respect to a decedent? If the QFP's are later paid, should not the related income tax liability be deductible as an estate liability?

2. Suppose a transferor sells the missed QFP instrument before he dies and receives cash in consideration from the transferee that takes into account the high probability that the missed QFP's will eventually be paid. The statute does not offer relief from IRC §2033's taxation of that cash, if the transferor dies after that cash sale has been transacted. The result is double taxation.

H. Several problems exist under IRC §2701(b), the intent of which is to value subsequent transfers of QFP interest consistent with the QFP rules:

1. For purposes of IRC §2701(d) is a transfer to a revocable trust a triggering event? The calculation under IRC §2701(d) seems to ignore any consideration received that exceeds the fair market value of the rights determined without regard to QFP rules.

2. The transferred QFP instruments will be deemed more valuable than they may actually be because it is assumed that the QFP rights will always be paid. This assumption ignores that QFP rights may be almost valueless, if the corporation is in substantial financial difficulty. Under IRC §2701(d), even if the corporation is in financial difficulty, substantial gift taxes and estate taxes may accrue because of the transfer of the QFP rights. The wording of IRC §2701(d)(2) should be reworked to require an increase in the value of the QFP to make it clear that such increase will entitle the decedent's estate to the IRC §1014 basis step-up.

1. Does the wording of IRC §2701(d)(3) prohibit an income tax basis step-up that would otherwise be allowed at death for a surviving spouse?

J. IRC §2701(d)(5) appears to apply to a termination of an annuity or unitrust interest in a GRIT like instrument. It is unclear exactly how this will apply:

1. What is the measure of the deemed gift which could occur upon termination of that GRIT type instrument?

2. What is the deemed amount received in such a GRIT termination?

3. What is received when a debt terminates?

K. IRC §2701(e) attempts to avoid a double tax by permitting a valuation, or reduction, for purposes of subsequent estate taxation of non-QFP interest. However, complete relief is not attained. For example, if a non-QFP interest in an entity is sold, and if that cash is retained in a transferor's estate, there is no relief under IRC §2033 for the estate taxes associated with the cash received for that non-QFP interest.

L. A double tax is also associated with any returns that are paid on non-QFP interests. No gift tax credit is provided for returns on non-QFP's that are actually paid. For instance, suppose a matriarch transfers her stock interest in a corporation but retains a non-QFP lease associated with one of the buildings of that corporation. To the extent lease payments are made there will be no gift tax credit for that cash which will be in the matriarch's estate. At the matriarch's later death the lease is decreased by the increased common stock gift value. However, no reduction is allowed with respect to the cash received. Therefore, under this fact situation the Chapter 14 scheme effectively results in a double tax.

M. Chapter 11 filings may be encouraged by marginal businesses to seek relief under IRC §2701(f)(1)(B)(i). During insolvency IRC §2701(f)(1)(B)(ii) extends the three year period for the annual gift tax exclusion on missed payments under QFPs'. However, insolvency does not waive the payment of gift tax. Thus, after the insolvency period as ended, the QFP will pay a potential massive gift tax. Furthermore, loans from family members will not be taken into account in the insolvency calculations. If a QFP holder waives payment outside a Chapter 11 proceeding a gift tax apparently is due and the business may recognize the debt forgiveness as income.

III. Section 2702 Problems

A. Many problems exist because of the wording of IRC §2702(a)(3), which provides the value is to be determined without regard to any right to use the property pursuant to a lease:

1. Is the building to be valued for estate tax purposes, if owned by a patriarch or matriarch, as if a child whom the patriarch or matriarch leases the building to has no use right? Is the building to be valued as if that tenant does not exist, but potentially could be replaced by a higher paying tenant? Is the building to be valued on the basis that that tenant does not exist, but a restriction exists which prohibits any tenant from using the space that is leased to that child?

2. What happens on the sale of a building? Assuming the parent receives adequate and full consideration from an unrelated buyer can a gift tax nevertheless accrue because of this special lease valuation rule? How are buy-sell agreements effected by this lease provision?

B. There appear to be many technical problems with IRC §2702(b):

1. What does "pursuant to a formula" mean? Is a fixed payment contract "pursuant to a formula"?

2. Does this statutory language require that the formula exclude the right of first refusal or the right to use the property under a lease? Must the formula include the effects of the IRC §2701(a)(2) valuation rules? How should a formula deal with the possibility that family members may not consent to the QFP rules?

IV. Trust Problems

Do exercises of power of appointments under trusts and the participation and trust distributions come under coverage of Chapter 14? Does distributions need to be QFP payments? If they need to be QFP payments and the trust distribution is not a QFP payment is the deemed gift made of the remaining trust properties? If so, who is the transferee of that gift?

STATEMENT OF JOHN E. WREN, PRESIDENT
REGIONAL AND DISTRIBUTION CARRIERS CONFERENCE, INC.

My name is John E. Wren. I am president of Lakeville Motor Express of St. Paul, Minnesota and I am president of the Regional and Distribution Carriers Conference, Inc. We are pleased to have the opportunity to comment on Chairman Rostenkowski's "discussion draft" regarding estate valuation freezes.

The Conference is the national trade association representing motor carriers that specialize primarily in local and regional freight distribution. The Conference's more than 300 members are principally family-owned businesses or closely-held corporations who operate in one or more states, delivering and picking-up general freight. They provide the essential link that gets goods delivered to stores and factories in thousands of communities across the nation. The Conference is affiliated with the American Trucking Associations.

Conference members operate in a very competitive market that rewards innovative, responsive, efficient and economical service. Typically, their businesses are the result of the enterprise of a founding family member who had the fortitude, perseverance and "get-up and go" to carve out a successful niche in what is easily the most competitive transportation mode.

My own experience is not unusual. I took over my father's regional truck line in 1974. In the last 16 years Lakeville Motor Express has grown into a \$15 million-a-year regional carrier serving six states through 23 terminal outlets in the upper Midwest. I employ 220 people as drivers, dock workers and office staff.

I am the third generation of ownership of Lakeville Motor Express, which was founded in 1920, and it would be a terrible shame and waste of a life's work if the estate tax laws as they now exist force my heirs to sell Lakeville to pay inheritance taxes in the case of my untimely death.

I haven't spent the last 16 years building this business to have it and my family's association with it disappear through a forced sale. This is our seventieth year of serving the people of Minnesota and the surrounding states, and I don't see why Lakeville shouldn't go on for another 70 years.

Furthermore, I haven't worked over these years simply for myself. I want my children to benefit from my work and abilities. I have a son whom I want in the business. But, in all honesty, I am uncertain as to how to share the business with him without incurring a hefty tax bill for him or me because of Section 2036(c) of the Internal Revenue Code. It is a real concern for me.

I expect it is an equally important concern for many of the members of our Conference who, like me, run family-owned and-controlled trucking firms. And, although Section 2036(c) might not discourage me from making Lakeville Motor Express an even larger firm, my lawyers and accountants tell me that it will discourage my children from growing the business as long they are exposed to an estate tax that can reach sixty cents on the dollar.

Speaking of lawyers and accountants, I have had to hire very expensive lawyers and accountants to plan my estate arrangements. Those arrangements are quite complex, solely because of our estate tax laws, and involve very costly insurance. Section 2036(c) has only made a complicated situation even worse, without any benefit to me or my family. And I don't even know whether 2036(c) is going to catch me in its "net" or not. My lawyers aren't sure, and I am told, not even the Treasury knows how to implement the law.

I am not a tax expert. But, is it really necessary to pass laws such as Section 2036(c), that are so complicated and hard to understand that not even the Treasury Department can figure out how to write rules to put the law into force? Why does Congress always want to change the rules of the ball game when we are in the 5th inning? I thought I had my estate properly planned some time ago, and then along comes this provision that turns every thing upside down. And, without any apparent productive purpose except to take a lot of money out of my pocket and give it to lawyers and accountants.

I should like to see Section 2036(c) repealed. If there are flagrant violations of tax law in estate planning practice, then single them out and make them illegal. Is that so difficult?

The "discussion draft" before the Committee does one good thing: it repeals Section 2036(c). What it replaces it with is a gift tax instead of an estate tax; but it is still too broad and complicated. It leaves a lot unsaid that will only make its implementation more difficult - which means more expense for me and millions of other family businesses.

Isn't the time long overdue to begin really simplifying our tax laws? I recently read an article in The Wall Street Journal that pointed out that even the ranking Republican on the Committee found that he couldn't figure his own income tax last year, even though he has authored much of our tax law. Even big business is reeling from the complexity of our tax laws, according to the article. So you can imagine how bad it is for a company of my size.

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In the 16 years since I assumed control of Lakeville, I have found myself spending more and more of my time complying with one set of new regulations after another. Government seems to be reaching into every corner of my business without any let up.

Today I have to meet an ever-growing number of rules about how I hire, fire, compensate my employees, and otherwise run my firm. None of these rules help me serve my customers better. None of them make me more competitive. In fact, they do the opposite: they increase my costs and expenditure of unproductive time without producing one dollar of additional revenue.

The subject before you - estate valuation freezes - is yet another example of Congress destroying any incentive for individuals to start up, build and pass on a business that offers a needed product or service to the American people. I urge you to find a way to eliminate the objectionable aspects of Section 2036(c) and concentrate your efforts on simply and clearly defining the estate planning practices that you consider illegal. Then small business owners such as myself can concentrate more of our time and energy on building more efficient and prosperous businesses to serve America and provide jobs and security for our employees.

Thank you.

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March 28, 1990

Robert J. Leonard, Esq.
 Chief Counsel
 Committee on Ways and Means
 United States House of Representatives
 1102 Longworth House Office Building
 Washington, D.C. 20515

Re: Discussion Draft of Bill to Replace IRC § 2036(c)

Dear Sir:

I have reviewed the discussion draft of a bill to repeal Section 2036(c) of the Internal Revenue Code and replace it with Sections 2701 through 2703. I am writing as a tax lawyer who has counseled clients from time to time on the impact of Section 2036(c), but I am not submitting this letter for any particular client.

The discussion draft provides that Section 2036(c) is repealed retroactively but does not provide an effective date for Sections 2701 through 2703. In my opinion, it would be unfair to make these sections retroactive. They radically alter settled principles of valuation and would expose taxpayers to enormous gift tax (and in some cases, presumably, generation-skipping tax) liabilities that were unforeseeable at the time of transfers made before their proposal.

Very truly yours,

Lemoine Skinner III
 Lemoine Skinner III

LS:vm

B2, 1014.TAA

STATEMENT OF THOMAS A. SOLBERG
HARTER, SECREST & EMERY

April 18, 1990

Committee on Ways and Means
United States House of Representatives
1102 Longworth Building
Washington, DC 20515

Gentlemen:

I want to first thank you for giving me the opportunity to make a statement before the Committee on this important legislative matter. Making discussion drafts of complex tax legislation available to practicing professionals is a very positive approach for Congress and taxpayers alike. I have been in engaged the practice of law for over 30 years and view myself as a business lawyer in the broadest sense. My practice clients are primarily closely held small business corporations and their owners. I am an advisor to my clients not only on their business legal matters, but also on matters relating to estate and tax planning.

In the course of advising my clients, it has been necessary for me to become familiar with Internal Revenue Code Section 2036(c). Due to the nature of my practice I have had extensive experience in advising clients on transactional legal issues that are impacted by the statute. It is from this vantage point that I offer the following statement on the discussion draft proposal to replace Section 2036(c) (the "Proposal"). The opinions expressed in this statement are solely those of the author. I represent no one other than myself as a practicing lawyer. While the opinions and commentary are my own, my experience tells me that they are shared by a multitude of closely held business owners and farmers throughout our nation, and by their professional advisors as well.

I. Policy Considerations

A. The Repeal of §2036(c)

The case for the repeal of §2036(c) is overwhelming and does not have to be reargued in this statement. The fact that Representative Archer's bill, H.R. 60, has over 200 co-sponsors demonstrates that Congress is well aware of the need for repeal. The fact that the Proposal includes such a repeal is clearly a positive-factor.

B. The Case for No Replacement

There no longer is a need for statutory curtailment of asset freezes. While freezes were popular in the 70's and early 80's, even then the tax and business structure of "freezing" transactions was so complex that only a small group of professional advisors could effectively deal with them, and few clients could afford the very substantial legal, accounting and valuation costs of structuring them. The mid-80's brought on a stream of cases, rulings and regulations which, in combination, made it not only risky, but doubtfully practical to continue to implement "freezes". Any "freeze" that has legal substance and would pass audit scrutiny ends up having no economic substance as a "freeze". Further, the great preponderance of family businesses today are "S" corporations due to significant income tax advantages. Since "S" corporations can only have one class of stock, this eliminates all freeze possibilities for all "S" corporations. In short, there is no practical need for legislation and the revenue impact of eliminating future asset "freezes" is grossly overstated. What is really needed to protect the integrity of the transfer tax system is the establishment of a reporting requirement for freeze transactions and increased audit surveillance of abusive transactions.

C. The Burden of Tax Legislation on Closely Held Businesses

Closely held businesses and their owners have been repeatedly battered by the deluge of tax legislation and regulation that has been placed on their shoulders. Since 1976, fifteen major tax legislative proposals have been enacted by Congress dealing with income or estate taxation, and all of them have significantly impacted small businesses and their owners. The small business owner is over his head in terms of statutory and regulatory compliance. To layer a complex and convoluted statutory scheme like §2036(c) or the current Proposal on top of everything else is just too much. It is now time for common sense and reason to prevail - it is time to end this nightmare for the closely held business owner. Repeal of §2036(c) with no replacement is the only sensible answer.

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D. The Burden of Tax Legislation on the System

Think of all of the money, time and priceless energy that has been wasted on the enactment of §2036(c) and its aftermath. Not only by Congressmen and their staff, but by Treasury, the IRS, the Joint Committee on Taxation, OMB and countless lawyers, accountants, bankers, insurance persons, financial planners, taxpayers and others. If all of the money, time and energy spent on legislative proposals like §2036(c) and the current Proposal were positively directed into requiring compliance with the current estate and gift tax system, it certainly would have a revenue positive impact.

E. The Need to Simplify Tax Legislation.

Laws, particularly tax laws, should be susceptible to understanding, not only by a handful of elitist tax lawyers, but by clients who are expected to evaluate the advice they are given and follow the laws. Few professionals understand §2036(c), and if the professionals do not understand, what chance do clients have? Clients engage in normal business transactions (like entering into leases or employment contracts) only to find that a technical application of a broad and complex statute puts their transaction in potential violation of a statute with significant adverse tax consequences. What is worse yet is that even if the issue is one that is identified, there are often no reliable answers and no reliable process for obtaining those answers.

F. The Need to Evaluate the Transfer Tax System as it Applies to Closely Held Businesses and their Owners

The American Institute of Certified Public Accountants in testimony before the Senate Committee on Small Business on September 13, 1989 took the position that Section 2036(c) should be repealed and any replacement legislation for §2036(c) should be placed on hold until such time as Congress has an opportunity to examine the transfer tax system and its current impact on small businesses. For Congress to undertake such a study would, indeed, be a very positive step and would send a signal to small business owners as well as farmers that Congress is still concerned about them. As a practical matter, small businesses and their owners cannot afford to have 60% of the value of the enterprise extracted from the enterprise at the time of each generational transfer. It was recently calculated that only 5% of the family businesses last for 3 generations and that our transfer tax system is the major contributor to this statistic. While sanctioning asset freezes may not be the most effective way for dealing with this problem, some mechanisms need to be explored to provide relief. The small enterprise system, as we have known it in America, is in jeopardy. Foreign financial interests are the principal beneficiaries of the current system, and they are eagerly taking up America's small business enterprises.

II. The Discussion Draft Proposal and its Qualified Fixed Payment Solution.

A. The Proposal Effectively Eliminates the Use of Preferred Stock in Closely Held Business Planning.

The Proposal assumes that preferred stock issued by closely held corporations will be valued based upon the application of market interest rates to produce an effective yield, and thus value, for the preferred stock. While the Proposal does not state how these test rates will be developed, the accompanying explanation states that the income stream will be valued "using appropriate market discount rates". What is the appropriate discount rate to be applied to a small fish wholesaler, a mom and pop grocery store or a small tool and die shop? Some have suggested that risks of this nature will require returns in excess of 20%. Under those circumstances, if the actual dividend rate on the preferred stock is 6% (the equivalent of $9\frac{1}{4}\%$ in after tax earnings), the stock will be valued at only a small fraction of its liquidating value and a significant gift will occur on its issuance. The only way to shore up the value of the preferred stock is to make the dividend rate 20%, but no small closely held business can afford that kind of payment on preferred stock. Worse yet, such a rate, or even half of that, would create a reverse freeze since the cumulative growth of the preferred stock income stream would undoubtedly exceed any growth, or rate of return, that might conceivably be anticipated with respect to the common stock. Unless special low test market rates are established by statute for preferred stock issued by closely held corporations (see proposal set forth in IV herein),

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the valuation methodology will act as a complete prohibition on the issuance of preferred stock. If this is the intended result, there is a simpler way to get there.

B. Closely Held Preferred Stock Should be Valued in the Context of its Issuance.

Preferred stock issued by closely held corporations is generally issued under special circumstances that involve factors that are not reflected in normal securities trading markets. To create a fiction that the party receiving the preferred stock has alternative investment opportunities available in the market lacks reality. Generally the issuance of such stock coincides with the intergenerational transfer of control of the business to younger family members. The senior generation wants to assume a passive role, and is willing to leave the decision-making to younger generation shareholders, but does not want to continue to expose their equity investment to the significant risks of the business, particularly under new and unproven management. A sale to family members is always a possibility, but frequently the size of the after-tax investment is so large that even an installment sale is not an economic reality. Unlike a sale occasioned by death, no insurance proceeds are available to fund the sale, so a compromise solution is necessary. Out of this crisis comes the preferred stock solution. The principal advantage of the preferred stock is the liquidating preference which it enjoys over the common stock owned by the younger generation. This equity cushion provides the element of security which the senior generation shareholder is looking for. The dividend yield on this type of preferred stock is typically very low and non-cumulative in recognition of the fact that there are severe limitations on the ability of most small businesses to service preferred stock dividend requirements, particularly when the dividend payment, unlike interest on debt, is not tax deductible to the corporation. This does not usually trouble the senior generation owner since he has the prospect of receiving some return on his preferred stock investment and he probably was receiving no return on his common stock that he formerly owned, given that most small businesses do not pay dividends. The preferred stock owner gives up the prospect for growth, but he receives in return the security of his investment which he bargained for and so he is satisfied that the exchange is fair.

Is there a loss to the transfer tax system in such an arrangement? That depends on many factors, including whether the common stock goes up or down and the income received on the preferred stock, if any. If a sale alternative had been pursued, a comparative analysis of revenue, gain or loss would depend on whether the after-tax proceeds of sale could have been invested over the remaining lifetime of the seller to restore the asset base to a value that exceeds the alternative value of the preferred stock and the income received on it. It is by no means a certainty that the transfer tax system suffered any loss or that it was compromised. Contrary to the view apparently held by certain staff personnel, closely held business values go both up and down. A review of the high small business casualty rate in our Bankruptcy Courts will confirm that.

C. There is no Need to Invent a Statutory Methodology to Value Preferred Stock.

Investment bankers and other security valuation experts have been valuing preferred stock for years. There is no need to adopt a complex statutory scheme to value preferred stock. The valuation confusion arises out of specially designed "bells and whistles" that are put on closely held preferred stock issues to support a value artificially. These "bells and whistles" are rights which the preferred shareholder can exercise on a discretionary basis (such as conversion rights, puts, liquidating rights and voting rights) and which, in the family context, may never be exercised. These artificial rights, which inflate preferred stock valuations, can be best dealt with by a simple statute that says for valuation purposes they are to be disregarded or, alternatively, that they are to be valued under the assumption that they will not be exercised to add value to the preferred stock. With such a rule, qualified appraisers and valuers will not have any trouble valuing the preferred stock with traditional valuation methodology. A proposal similar to this was recommended by the American Bar Association ad hoc task force in July, 1989, but was rejected by Treasury as not being sufficiently comprehensive since it gave up too much of the ground that Treasury gained through the enactment of §2036(c).

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D. The Definition of Qualified Fixed Payments ("QFP") Should be Limited to Equity Interests.

Most of the inequity and uncertainty that developed from §2036(c) resulted from the concept that debt, leases, contracts, options and other intangible property rights served to create disproportionality. The Proposal uses the term "interest in the entity" in defining the requirements of a QFP, but does not define that term except to later say that any indebtedness or lease shall be treated as an interest in the entity. Presumably this leaves the door wide open for regulations to establish the boundaries of the term "interest in the entity". We have been down the "safe harbor" road once before in §2036(c) and that simply turned into a vehicle for the regulators to expand the statute and create uncertainty for its "chilling effect". The intent of the Proposal was to eliminate valuation abuse in the issuance and transfer of equity interests. This can be effectively accomplished by limiting the term "interest in the entity" to equity interests and not having it comprehend a concept that any stream of payments from an entity (irrespective of the value received) is potentially such an interest. If valuation or other tax problems arise with respect to promissory notes, leases or other instruments which do not reflect value received, there are many sections of the Internal Revenue Code, as well as case law developed doctrines, that adequately deal with these problems.

E. The Minimum "Junior Equity" Rule.

The rule which requires a minimum junior equity equal to 20% of total equity is not required. Existing valuation principles applicable to preferred stock already consider the asset coverage ratio and the dividend coverage ratio of the preferred stock. If an effort is made to "sop up" the entire shareholders' equity in preferred stock (to place a nominal value on the common stock) the effect of this will be to reduce the asset coverage ratio and dividend coverage ratio of the preferred stock down to a point where the preferred stock will only be valued at a fraction of its liquidation preference. This will, in turn, increase the value of the common stock. No statutory provision is required to produce this result, since the valuation concept is well established and was, in fact, memorialized in the Service's own ruling on valuing preferred stock, Rev. Rul. 83-120.

The other problem with the minimum equity rule is the inclusion of shareholder debt as equity. The rule was obviously put in place to deal with abusive debt-equity ratios, but catches within its net all shareholder debt irrespective of the debt-equity ratio. The rule would penalize any corporation which could qualify for bank debt, but where shareholders (for whatever reason) prefer to lend the corporation its financial requirements. The statute also fails to take into consideration bank debt supported by shareholder guaranties, entity debt from related entities, entity debt supported by guaranties of related entities and entity debt supported by collateral from shareholders or from related entities. Since existing preferred stock valuation principles already deal with the minimum junior equity problem, it seems unnecessary to recreate those same principles by statutory mandate and at the same time introduce arbitrariness, inequity and uncertainty.

F. The Statute Does Not Effectively Deal With Hybrid Securities.

Since the Proposal conceived the term "equity interest" in the context of the classic preferred stock recapitalization, it also conceived that the equity interests would fit the classic definition of either common stock or preferred stock. In doing so, the Proposal does not effectively deal with the myriad of hybrid equity interests that are frequently encountered today. For example, the statute applies to the retention of any equity interest if the interest has any preferential rights. It is not uncommon for corporations to have two classes of common stock, each having a limited liquidating preference, with equal participation after the preference amounts are paid out to each class of common. If there is good asset coverage on the preferences, each class of common will have equal value as a practical matter, and yet, under the Proposal, the security with the first preference would be valued at zero. Problems of this nature are even more frequently encountered in partnerships since it is common in real estate development partnerships and oil and gas partnerships to have limited preferences permitting a return of capital followed by income sharing. Another security that does not fit well into the proposal is a preferred stock or partnership equity interest with a dividend or income payment that is part cumulative and part non-cumulative, or that is non-cumulative and has a "make-up" right on liquidation. These same problems with hybrid securities were

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encountered under §2036(c) and never successfully resolved in any fair or equitable manner.

G. Debt Subject to Contractual Restrictions.

Debt falls within the definition of a QFP if the payment is fixed as to both amount and time. This would include shareholder debt. Payment of shareholder debt is frequently subject to restrictions imposed by third party contracts such as subordination agreements and bank term loan agreements. While the statute contemplates the inability of the borrower to pay the debt due to insolvency or bankruptcy and provides relief from the "deemed gift" rule, it does not effectively deal with non-payment due to contractual restrictions which ripen due to defaults in loan agreements and similar documents. In view of the frequency and business significance of these types of restrictions, the definition of QFP should be clarified to provide that such restrictions do not make the payment provisions conditional. Further, nonpayment by reason of defaults which trigger repayment restrictions should not result in "deemed gifts".

H. Leases as QFP's and the Fixed Payment Requirement.

The Proposal would include leases as QFP's. Many commercial leases would not meet the definition of a QFP since they do not meet the final payment requirement. One example would be retail store leases which almost all have percentage rent clauses. This reinforces the argument that "entity interests" should be limited to equity interests.

I. The Proposal Needs a Better Solution For Noncumulative Preferred Stock.

For reasons discussed earlier, it is not uncommon for closely held corporations, where income and cash flow are uncertain, to issue noncumulative preferred stock. Under the Proposal the holder can elect to have noncumulative preferred stock treated as a QFP. If the election is not made, the noncumulative preferred stock will be assigned no value and an overvaluation of the common stock will result. If the election is made, and if the noncumulative dividend is not paid for a period exceeding three years, the lapsed payments constitute deemed gifts, even though there may be significant business reasons justifying, indeed necessitating, non-payment. Under current law a court would look at the facts and circumstances to determine whether a constructive gift had occurred. If the Proposal is enacted, a case law doctrine producing a reasoned result will be replaced with an arbitrary statutory result that is unfair to the preferred stockholder. The same problem exists with respect to partnership payments when the right to payment is contingent on or limited by income or cash flow of the partnership.

J. The Compounding Rule for Unpaid Cumulative Dividends Creates a Reverse Freeze.

In order to have unpaid cumulative dividends not be regarded as deemed gifts, they must provide for compound interest on arrearages, presumably at market interest rates. This will be undoubtedly result in a reverse freeze for the holder of the preferred stock since the market rate accumulation will produce growth faster on the preferred stock than any likely potential growth that might take place on the common stock.

K. The Application of the Deemed Gift Rule to Transfers of the QFP.

The holder of a QFP who transfers the QFP is to be treated as having made a deemed gift equal to the difference, if any, between the QFP valued under the Proposal provisions and the actual fair market value of the QFP. While there might be a rationale to support this rule in gift transfers, the rule should operate both ways to allow a tax refund or credit if the fair market value exceeds the special valuation computed value. The same rule might be applied to sales to family members. However, I believe that the transfer section should contain a complete exclusion for any arms-length sale negotiated with an unrelated third party. There is no opportunity for valuation abuse under those circumstances since the transferor's economic interests are served by maximizing the purchase price. The estate tax valuation adjustment in the related subsection should likewise exclude value increases if value is fixed by an actual sale to an unrelated third party. It should also provide for a tax basis increase for the asset if a valuation differential is included in the estate with respect to such asset.

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L. The Insolvency Exception Needs to be Expanded by Redefining the Term "Insolvency".

With respect to QFP's, the Proposal provides relief from the deemed gift rules if the payor of the QFP is "insolvent". The Proposal adopts the IRC §108(d)(3) definition of insolvency except it specifically excludes any debt due to the holder of the QFP from the insolvency computation. There is no reasonable basis, in this context, to exclude related party debt from the definition of insolvency. IRC §108(d)(3) states that insolvency exists if the liabilities exceed the fair market value of the assets. This definition is too narrow and needs to be expanded to cover any circumstance under which the holder of the QFP cannot obtain payment after pursuing all legal remedies available to such holder. While most instances would seemingly meet the insolvency test under those circumstances, the subjective nature of the test, requiring a determination of fair market value of assets, is not certain enough. It is bad enough not to get paid, it is worse to simultaneously incur tax liability for a deemed gift.

The deemed gift rule should also be suspended where contract moratoriums are negotiated in good faith between the debtor and creditor. Frequently, a determination is made that the only way to get paid eventually is to grant some current debtor relief by way of forgiveness or extensions of time. While this is frequently worked out in a Chapter 11 proceeding, it is sometimes worked out in state court proceedings or by private agreement to minimize administrative expenses and delays.

M. The Attribution Rules Need Redefinition.

Section 2703(b), which is the only entity attribution rule, states that a right or interest will be treated as held by an individual if such right is held "indirectly" by such person through a corporation, partnership, trust or other entity. This begs the question, since it does not tell us when an entity right will be deemed to be held "indirectly" by a person. The family attribution rule should be limited to spouses and lineal descendants.

N. Post Death Transfers Should be Excluded From the Proposal.

Release 89-99 made it clear that Section 2036(c) did not apply to a post death recapitalization under a direction contained in a Will. Transfers involved in such a recapitalization should be likewise excluded from the Proposal.

O. The Proposal Needs to Provide Broad Grandfathering of Prior Transactions.

Section 2036(c) contained broad grandfathering provisions for transactions antedating the effective date. Not only were transactions grandfathered, but in the case of preferred stock, the failure to pay preferred stock dividends or the failure to convert the preferred stock to common following the adoption of the statute did not constitute disproportionate transfers. Similar provisions are required with respect to the Proposal.

P. The Regulatory Authority of Treasury Should be Limited.

The regulatory authority given to Treasury should be very limited so as to force the enactment of a statute from whose language taxpayers can determine their basic rights and obligations. When broad regulatory authority is granted, the regulators become legislators, as has been the case with §2036(c). Taxpayers are entitled to hold Congress responsible for tax legislation and this process can only be effective if regulatory authority is curtailed. Taxpayers and their professional advisors can no longer live with the concept that they must wait several years to find out how the regulatory authorities are going to interpret a broad or vague statute.

By way of example, Section 2703(c) should be changed so that changes in capital structure will be treated as transfers only "to the extent" provided in regulations" and not "except as provided in regulations". This properly places the burden on Treasury to establish transactional guidelines for "in effect" transfers.

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III. The Option Rule

A. The Option Rule Inhibits Intergenerational Transfers of Closely Held Business Interests

The option rule eats at the heart of the shareholders buy-sell agreement. Almost every closely held small business with more than one owner has a shareholders agreement which restricts lifetime transfers of shares and provides for a mandatory option to purchase shares on the death of a shareholder. The lifetime restriction controls the transfer of shares while the owners are alive. The mandatory purchase option at death provides a guaranteed market for the shares of a deceased shareholder. This is very important since there otherwise may be no market for such shares. Such mandated sales provide needed liquidity to pay estate taxes and estate expenses. The option also lets the deceased shareholder arrange the price and terms of sale for his estate while he is still alive. For the surviving shareholder, the option enables him to agree on a price for the shares (whether by formula or otherwise) and this, in turn, enables him to arrange terms of sale or insurance funding which will make the purchase economically feasible. Fundamental to the arrangement is that the price for the shares is set (whether by formula or otherwise) at the time the option agreement is entered into so that each party can plan his estate (if he is the first to die) or the purchase and transition of the business (if he is the survivor) with some degree of certainty.

The Proposal states that where options are held by family members (as is the case in every family corporation) the shares of the deceased shareholder are to be valued without regard for the option price set forth in the shareholders agreement unless the option price is determined by a formula, is subject to a review every three years and at the time of each review it is determined that the formula is reasonably expected to produce fair market value at the time of sale. To require a periodic review and renegotiation of the option pricing formula every three years, in effect, takes away the prime benefit of the option which is price stability and the ability to plan the funding of the purchase price in advance with some certainty. Without the benefit of purchase options, the intergenerational transfer of closely held business interests will be greatly inhibited.

It is true that the Proposal does not prohibit shareholder agreements that do not meet the criteria of the option exception, but in those cases the option price will be disregarded for estate tax valuation purposes. This prospect offers the worst of two worlds! The decedent's estate must sell the shares at the option price, but if fair market value, determined independent of the option agreement, is determined to be significantly greater than the option price, the estate tax on the shares could be greater than the sale proceeds. Nevertheless, if all of the exception's criteria are not met (including the subjective "fair market value" test), that is the problem the decedent and his beneficiaries would end up with.

B. The Purchase Option is the Principal Employment Incentive Available to Closely Held Family Businesses.

Small closely held family businesses do not have the ability, from a financial viewpoint, to compete with larger publicly held companies in terms of executive compensation. Neither do they have marketable stock to use in stock option plans or stock bonus plans. The principal inducement for family members to remain in the family business in the long term prospect of being able to acquire control of the business on terms and at a price that is both fair and one that they will be able to afford. The only way to guarantee this is through a shareholders option agreement. Such an arrangement will hold no benefit for them if they have to renegotiate the pricing terms every three years and surrender any leverage the option agreement may have obtained for them.

C. There is No Need for the Option Rule

The option rule is not necessary to protect the integrity of the transfer tax system. Existing estate tax regulations currently do this very adequately. Treasury Regulation §20.2031-2(h) is very explicit on how shares subject to options are to be valued. This regulation recognizes that the potential abuse by "low-ball" pricing in family options and clearly states that the option is to be disregarded unless it "represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in

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money or money's worth". This estate tax regulation serves the transfer tax system very well. It is well understood by taxpayers, it is well settled by case law and should not be replaced with a new rule which causes wide ranging substantive and procedural problems.

D. The Option Rule Makes No Sense Where Both Family Members and Unrelated Parties Hold Similar Options

Frequently family members and non-family members will have identical option rights under the same shareholders agreement. It does not seem fair or practical to continually renegotiate price with family members but let non-family members retain the benefit of their bargained for options. On the other hand, if the agreement does not meet the formula pricing review requirements of the Proposal, how does the estate value the shares? Is the stock optioned by non-family members valued based on the option price and the stock optioned by family members valued as if the option did not exist? This could result in two different values for the same security in a single estate. The answer is that the Proposal's option rule should never apply when there are non-family members holding identical options to those held by family members.

E. The Proposal's "Fair Market Value" Requirement for Option Pricing is Not Practical or Workable.

In order for an option to control the estate tax value of shares, the proposal would, among other things, require the option price to be established by a formula "reasonably expected to produce a price which would approximate fair market value of such property as of the time of such sale". (emphasis added) This subjective test introduces a significant element of uncertainty. There is no way for the parties to know whether they have met this test and the Service will not issue advance rulings on the question. Valuation issues on closely-held stock are already the central focus of all estate tax field audits and have turned the audit procedure into an estate tax negotiation due to the overly aggressive valuation positions taken by field agents. This rule will only aggravate the audit problems and produce more appeals and valuation litigation. Failure to meet the test will mean that the stock, although sold under the option, will be valued as if the option did not exist. This presents the potentially disastrous result discussed in Section A, above.

The Tax Court has said that valuation of closely held stock is an art and not a science. The large number of valuation cases clogging the Tax Court docket demonstrates that value is in the eye of the beholder and is an issue over which acknowledged experts can have widely divergent views. Given this scenario, how are the parties to an option ever to know if the pricing mechanism is reasonably expected to produce fair market value at some point in the far distant future. Perhaps they could get a professional appraiser to express an opinion on this prior to entering into the option agreement, but there is nothing in the Proposal that would protect them if they got such an opinion. And is it fair to small businesses to impose on them a \$10,000 - \$20,000 cost for a valuation opinion every time a shareholders agreement is entered into?

Perhaps it is the shareholders' reasonable expectation that the statute is referring to and that if they form a good faith judgment about the formula and fair market value, then there is a conclusive presumption that the test is met. This would probably turn the requirement into a nullity, since shareholders frequently know a great deal about their businesses, but usually know nothing about its value or how value is determined.

F. The "Formula Review" Requirement of the Proposal is Not Practical or Workable.

The Proposal requires a review of the option pricing formula every 3 years in order for the option price to be a factor in the estate valuation of the property. The purpose of the review is to determine whether the formula option price originally selected continues to provide a reasonable expectation of a selling price which will approximate fair market value at the time of the sale. Aside from the process itself, the term "approximately" used in conjunction with the "fair market value" illustrates the impracticability of the rule itself and will surely spawn more litigation. The rule suggests that all shareholder option agreements to which family members are a party be drafted with price reopeners at the end of every three year period. This could obviously lead to subsequent impasse over price and no agreement at all. Any shareholder who made a bad bargain could bail out. What value would such an agreement provide to any party? It

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is doubtful whether such an option agreement would meet the current test under the §2031 regulations since the agreement would effectively provide all parties with an escape hatch. Finally, the same questions regarding the determination of fair market value (See Section E above) would occur all over again at 3 year intervals. The rule is well calculated not to please anyone other than professional appraisers.

G. The Proposal Requirement That Option Pricing be Established by a "Formula" is Too Restrictive.

The Proposal requires that the option pricing be established by a formula. This, in itself, implies the necessity to use a professional appraiser since shareholders know very little about option pricing formulas. This is also contrary to the current practice of most closely held corporation shareholder agreements which do not generally utilize formula pricing for options. While large publicly held corporations have the operational stability to create a predictable result with earnings or cash flow formulas, the uncertainty of the financial results in the small closely held business creates a high level of discomfort among shareholders when formula pricing is suggested. Most frequently, shareholders (whether or not related) would rather look to book values, asset values, liquidating values, appraisals or simply fix an option price at a monetized amount by mutual agreement. In the latter case, the agreement may provide for periodic reviews with some automatic price adjustment if agreement can not be reached after the review. It is not clear that any of these pricing methods would constitute a "formula". In the closely held corporation context, shareholders are looking for a pricing mechanism that will offer them stability and a dependable and foreseeable result, and will often sacrifice the opportunity to maximize value to achieve those ends. The Proposal should be satisfied if the "approximately fair market value" test is achieved by the parties, and not require them to achieve it by "formula".

H. Disregarding Rights of First Refusal and Leases Ignores Realty.

The Proposal would ignore rights of first refusal in valuing property if the right is held by a family member. Rights of first refusal are very common in lease transactions and should be given their contractual effect in valuations of such property. Likewise, if property is subject to a legally binding lease, the economic impact of the lease should be considered in valuing the lease. To do otherwise would preclude leases and rights of first refusal among related parties since the asset would be valued in the estate as if the contractual right did not exist, but the contractual right could, nevertheless, be enforced.

I. Other Technical Suggestions

The three year review requirement would be better tied to the date of death rather than the date of sale. The six month prohibition on resales should not tie into the date of death, but rather to the date of transfer under the option. The option exceptions only apply if there is not a "readily ascertainable market value" for the property. This term needs a definition or a cross-referencing to other sections of the Code that provide a definition of the term.

IV. A Proposal to Create a Safe Harbor for Small Business Preferred Stock.

The current Proposal effectively creates a prohibition on preferred stock recapitalizations. Requiring the preferred stock to be valued based on a market rate index puts them out of reach as a practical matter. Many small closely held businesses continue to require the availability of some limited form of preferred stock recapitalization if intergenerational transfers of family businesses are to continue to be a reality. There is a Congressional policy which recognizes that small businesses need special considerations, particularly in dealing with the transfer tax system. My proposal should create a statutory safe harbor which would permit any closely held corporation to issue up to \$2,000,000 in cumulative preferred stock and not have that preferred stock valued by the rules of §2701(a)(2). Such stock would be valued based on a statutory index dividend rate set at 4% per annum. The deemed gift rule would apply to any dividend not paid for three years, but the preferred stock shareholder would have the right to treat the deemed gift as a present interest gift so long as the holder of the common stock holds a current "put" against the corporation (or the preferred shareholder) equal to the accumulated and unpaid dividends on the preferred stock. Under such circumstances the

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preferred shareholder would be entitled to apply his annual gift tax exclusion to cover all or a part of any deemed gift created by any failure to pay the dividend. The minimum junior equity rule (without the shareholder debt included) would apply to such preferred stock and reporting requirements would be established to report the recapitalization and all deemed gifts, whether or not covered by the annual gift tax exclusion. Non-cumulative preferred stock would not qualify for the safe harbor. The amount of the preferred stock permitted to be issued under this proposal would be indexed for inflation or deflation. The deemed gift rule on transfer would apply as would the special valuation rule on the death of the transferor and the spousal exception.

This would permit some limited relief for owners of closely held family businesses. It is certainly in the furtherance of the Congressional policy to assist small business and, in principle, is not unlike statutory relief currently granted to closely held businesses and farmers under IRC §§303, 2032A and 6166. Having a 4% interest rate as an index valuation rate reflects a fair return for the exchanging shareholder considering all the circumstances, a dividend payment that the closely held corporation could generally afford to pay and otherwise protects the integrity of the transfer tax system. The dollar limitation on the preferred stock will continue to make it useful primarily to the small closely held business and will prevent abuse and significant loss of tax revenue. Most importantly, this safe harbor proposal would answer the criticisms of small business owners.

V. Summary

- A. Section 2036(a) should be repealed.
- B. It is doubtful whether a replacement is required. Existing tax statutes and doctrines if vigorously enforced can deal with the perceived problem. The system cannot accommodate another major tax proposal of this magnitude.
- C. Before enacting any further legislation, Congress should undertake a study of the transfer tax system and its current impact on small business.
- D. If the Proposal is adopted, it should have a much narrower focus and its structure and operation should be greatly simplified.
- E. Under no circumstances should the "option" provision be included in the Proposal.
- F. A "safe harbor" should be established for a limited issue of small business preferred stock.

STATEMENT SUBMITTED FOR THE HEARING RECORD by
SOUTHEASTERN LUMBER MANUFACTURERS ASSOCIATION

SUBJECT: DISCUSSION DRAFT PROPOSAL TO REPLACE SECTION
2036(c) OF THE INTERNAL REVENUE CODE

BEFORE: HOUSE COMMITTEE ON WAYS AND MEANS

DATE: MAY 7, 1990

The membership of the Southeastern Lumber Manufacturer's Association (SLMA), appreciates the opportunity to submit comments for the hearing record on the proposed discussion draft legislation to repeal and replace section 2036(c) of the Internal Revenue Code. SLMA represents 375 lumber mills throughout the southeast, and its membership has a strong interest in issues which impact on a family owned business.

BACKGROUND

Section 2036(c) was enacted as a part of the Revenue Act of 1987, to curb abuses prevalent in implementing an estate freeze recapitalization by a closely held business. The new law is designed to prevent the untaxed transfer of appreciated assets between generations under any circumstances.

Unfortunately section 2036(c) did not simply curb abuses. Section 2036(c) totally eliminated the ability of any business owner to craft an estate freeze recapitalization that would provide the business owner and his heirs with any tax certainty.

However, section 2036(c) does not simply impact on estate freeze recapitalizations. The net of Section 2036(c) is cast so broad that any financial transaction that occurred between generations could have an estate tax implication.

REPEAL OF SECTION 2036(c)**THE CONTROVERSY OVER DEFINING ABUSIVE VALUATIONS**

In the Revenue Act of 1987 Congress enacted new Section 2036(c) of the Internal Revenue Code (IRC), to reduce the benefits available from an estate freeze. The purpose of the statute was to prohibit the transfer of appreciated property between generations and bypassing the Estate and Gift tax rules.

At the heart of the controversy over estate freezes are the rules by which businesses, individual assets of a business, individual rights of a stockholder to receive future income from the business, and the rights to future appreciation of the business are valued in a closely held business.

The art of valuation lies at the heart of the estate and gift tax system where taxes levied are based on these valuations. These questions of valuation are rendered even more complex when posed in a closely held business, for although IRS regulations specify factors to be used in determining value, value can seldom be ascertained on a mechanical basis. Typically its determination results from a balancing of factors and circumstances.

Publicly held companies are vastly larger and more diversified than privately held businesses. Therefore the future income of a publicly held company is generally not dependent on any single business, fashion, trend, geographic area, or one person or group of persons. Basic financing patterns of a closely held business is more reliant on debt than equity as in a public corporation. The greater reliance on debt also will result in wider variations in profits than would ordinarily be the case in a public corporation.

A closely held business owner faces seemingly unsurmountable obstacles in trying to fashion a plan for insuring the survival of his business. Whether the need is to plan for an orderly transfer of the business between generations or for a plan that provides for continuity of the business in the face of an untimely or accidental death, the obstacles presented by current 2036(c) are damning to these goals.

Section 2036(c) puts all estate planning on hold and an individual who owned a family business began to consider whether he might be better off selling his business and simply giving his heirs the proceeds directly.

STATUTORY REPLACEMENT FOR SECTION 2036(c)

A statutory replacement for Section 2036(c) is realistic and desirable if the new statute is targeted to the primary abuses that 2036(c) initially sought to address. Any proposal to replace 2036(c) should be limited in scope. It should focus on the concern of preventing abusive valuations and preventing the owner of a closely held business from passing substantially appreciated assets through the transfer tax system without taxation.

However, it also should allow a business owner to craft a plan that is fair and representative of the facts. This planning ability must recognize the unique and often unsettling nature of a closely held business that can be subjected to variations in profits and incomes over many years. It also must provide for certainty in the process. The business owner should be aware of his obligations and it would be fair for the IRS to require adherence by the business owner to his plan and obligations agreed to under the plan.

WAYS AND MEANS DISCUSSION DRAFT

In March the House Ways and Means Committee introduced a discussion draft for a possible replacement of Section 2036(c). The draft proposal sets out some new ideas and concepts for a statute that would permit recapitalizations of closely held businesses with the goal of allowing orderly transfers of assets between generations.

At the heart of the proposal is the idea that upon undertaking a recapitalization transaction that the obligations undertaken by the parties to the recapitalization are adhered to. Where under the law in effect before enactment of 2036(c) these rights were the subject of valuation questions, the discussion draft seeks to solve this problem by limiting those rights that may be ascribed value in a recapitalization.

Most of the discretionary rights valued in an estate freeze recapitalization would have no value under this draft. The only right that would have value is one that resulted in a Qualified Fixed Payment (QFP). This concept eliminates the ability of the parties to ascribe value to a wide variety of discretionary rights and as a result to place a value on a discretionary right that the parties would never seek to exercise.

Second, if a taxpayer fails to receive a dividend payment under such an arrangement, within three years of the dividend payment date the dividend is treated as a gift to the common shareholders, triggering a gift tax. This is the failsafe mechanism which proponents believe makes this proposal work.

It is fair to say that any replacement statute should not allow for unrealistic valuations or for the ability to transfer appreciated assets in a tax free manner. It is also fair to say that a proposal of this nature becomes acceptable or unacceptable depending on the individual's understanding of the function and need for certain discretionary rights.

ISSUES OF CONCERN WITH DISCUSSION DRAFTValuation of Stock

In the typical recapitalization the owners of the business transfer their common stock to their children and receive preferred stock in its place. This transaction allows the children to benefit from their efforts and the future growth of the business while the parents would have an income stream from the preferred stock.

The value of the common transferred is critical because this determination results in a gift tax at the date of the recapitalization. Of course the method of valuation of the preferred stock is critical because it forms the basis for valuation of the transaction.

The draft would restrict the valuation of the preferred to zero, unless it provided for a fixed and certain stream of payments that give the preferred stock value. The requirement for a QFP means that only if the rights to the dividends from the preferred are cumulative is the payment considered a QFP.

The draft then goes on to allow only two variations from the cumulative preferred rule. An election is provided so that non-cumulative preferred stock can be treated as a QFP if it meets certain specific requirements, and voting rights can be valued within the recapitalization. By definition then all other rights would have a zero value for purposes of an estate freeze recapitalization.

The QFP amounts agreed upon would have to be paid within three years of their due date, or an additional gift tax must be paid by the children. Exceptions allow for a missed dividend if a compounding feature is built into the stock that would increase the value of the dividend until it was paid based on current interest rates, or the dividend can be added to the estate at death.

Limitation on Value of Discretionary Rights

The proposed limits on the various discretionary rights seems far too severe for there are circumstances where in a firm a discretionary right is important, even if it never is exercised. Rights to purchase common or to share in the future appreciation of the company with a conversion right has a determinable value that should be allowed recognition.

One suggestion is that a broader review and listing of those rights that are considered abusive should be undertaken by staff. A listing of those clearly abusive rights might be made so as to separate them from those rights that do have a value that can be independently verified.

The rules also should be internally consistent and if a value of zero is ascribed for gift tax purposes it also should follow that the same value should result for estate tax purposes at death. The rule should not place the IRS in so superior a position that they can disregard certain rights when it is to their benefit, but then turn around and include these same rights when it is to their benefit. This inconsistency will harm the discipline of the whole system by creating vast future uncertainties.

Twenty Percent Rule

The discussion draft proposes that the common stock transferred to the children must not be valued at less than 20% of the total value of all the equity interests, plus, the total amount of indebtedness of such entity to the transferor.

Including indebtedness in this equation can cause problems for included ion the debt there might be debt to deferred compensation plans, retirement plans, and qualified debt that might have a perfectly valid business purpose. By having this rule the door is left open for the service to consider issues of compensation and control. These issues are very complex and have intentionally been set aside in the context of this draft.

The 20% rule itself is curious and seems out of sync with the rest of the proposal, because it places too great reliance on increasing the value of the common stock while reducing the value of the preferred. One would question the need for this safe harbor approach if the other valuation principles are sound, it would seem that this concept is out of place.

Determination of Market Dividend Rate

The value of the preferred stock is affected by the dividend rate that the parents will receive. In establishing a value on the preferred stock the chosen rate must be compared with the market rate at the time of the recapitalization, and if it is below market the value of the preferred is reduced by a percentage comparing the actual rate to market rates. This can have the effect of increasing the value of the common and increasing the gift tax due at the time of the recapitalization.

A major concern is that the definition of market rate for a security of a closely held business should not result in a rate so high that it practically prohibits freezes. Obviously dividend rates far below market are a transparent attempt to shift value. However, requiring a rate far above market rates for other grades of paper would not permit too many recapitalizations to occur.

The concern is that by requiring a rate that is too high discriminates between the business owner whose assets are tied up in his business over the business owner who is wealthier and can simply transfer cash to his children. The uncertainty is best illustrated by an overly zealous IRS agent who might review the whole transaction ten or fifteen years after the fact.

We have a concern that there be some clear guidelines in the proposal to define market rate, or without such guidance that consideration be given that market rates be limited in some manner, much as has been done in the imputed interest rules.

Deemed Gift Rule For Preferred Stock Dividends

The dividend payment rule requires that upon failure to pay the dividend by the third year, that such debt is treated as a gift and that a gift tax be due. There is no exception for hardships except for bankruptcy or liquidation.

A closely held business can find that because of style shifts, changing markets, or simply increased interest rates on debt, that payment of a dividend is not simply a hardship but could place the business at risk. How many suppliers would accept the excuse that their checks will have to wait because the IRS requires that I make my dividend payments. Violations of loan agreements and the good will of suppliers are at risk under these circumstances.

A hardship rule is necessary and important to allow a deferral of time without gift tax for the dividend to be paid, to allow the business to work out its difficulties. Tax law already makes such provisions under the Earnings and Profits Tests that a company must make before paying a regular dividend.

Buy Sell Agreements

Buy sell agreements would have to be revalued every three years under the proposal whether they were a part of a recapitalization or not.

Use of buy sell agreements are critical and very important to closely held businesses. These agreements typically are used to protect the business and to insure that in the event of an untimely death that the businesses owners will remain with the family members.

The changes to the buy sell agreements outside of a recapitalization have been a longstanding concern of the IRS. However, this issue should not be addressed within the context of the estate freeze rules. This issue should best be addressed separately from the concern with the estate freeze abuses.

OTHER ISSUES OF CONCERN

Of equal concern to SLMA are the following issues:

- * Complex elections that might inadvertently be missed should be simplified.
- * Requirement for mutual consent of all family members to deemed gift rule.
- * Extension of the statute of limitations from three to six years and no limitations on a variety of required notifications that are not listed.

The membership of SLMA appreciates the opportunity to share our concerns over the proposed replacement for section 2036(c) with you. We look forward to commenting on any proposed changes that might be proposed by the committee in the future.

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RE: 11 U.S.C. Section 2036(c)

ATTENTION: Harriet Lawler

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11 U.S.C. Section 2036(c)-"THE FREEZE"

I. POLICY RATIONALE FOR TAXES.

Certain axioms govern the world of taxes. The Federal government exists to serve its people. To do this, the government needs money. To obtain this money, the government imposes taxes. Thus, taxes must reflect the needs of the people served, and tax statutes must be written so that the people served have confidence in the statutes that impose that tax.

To this end, five social policy concerns exist. First, a sense of trust must exist in the Federal government's ability to treat taxpayers of different socioeconomic backgrounds justly by preserving an equilibrium between horizontal and vertical equity. Second, there must be an effort to preserve the economic philosophy of the United States, i.e., 1). to encourage entrepreneurial enterprise, including family-run closely-held businesses, and 2)., to foster the continuation of the family farm. Third, all tax statutes should be easy to administer, thereby lessening the cost of enforcement for noncompliance. This can be accomplished with the use of existing tax statutes and code regulations which would thereby eliminate redundancy in the tax code. Fourthly, a tax statute should be drafted to forestall the need for future judicial interpretation. This would lessen an already overloaded Court system by the utilization of existing judicial precedent. Finally, as concerns 11 U.S.C. Section 2036 (c), a tax statute should provide an inclusive taxation provision that addresses the Federal government's concerns about the tax-free transfer of appreciated assets while at the same time satisfying taxpayer needs for a workable, and donative transfer-taxing process. The present statute satisfies none of these social policy concerns.

II. PROBLEMS WITH THE PRESENT LAW-11 U.S.C. Section 2036(c).

Problems with 11 U.S.C. Section 2036(c) center in four areas. The first area addresses the social policy concern of trust by the taxpayer. This area centers on the confusion that the statute causes, and the sense of unfairness the taxpayers feel when they try to abide by this law. As the statute now exists, even professionals say that "the ambiguous wording of Section 2036(c) creates great uncertainties as to what is allowed"¹ and that "no one is sure whether, or how, it works."² Therefore, "only the sophisticated, who have the time, wit and stake to grasp the worst implications of Section 2036(c), are likely to know how to avoid difficulties."³ Thus "[t]wo years after enactment of Section 2036(c), taxpayers still have little guidance except the statute

¹ Jan. H. Rosen, "Tax Watch", New York Times, Oct. 2, 1989, at 26, col. 1.

² John A. Bogdanaki, Lawrence R. Brown, "Farewell to 'Freezes: Section 2036(c)", Tax Analysts, Special Report, Mar. 27, 1989, pg. 1633-1655 at 1651.

³ supra at 1654.

itself."⁴ As a result, "application of the tax cannot be predicted with certainty, which is always bad in a voluntary compliance system."⁵ As noted, this area of concern also centers on the debate about the fairness of Section 2036(c) and the resultant discontent among taxpayers. As the statute now stands "family members are treated worse than non-family members if full consideration is paid, but family members are treated better than non-family members if the consideration paid is not full."⁶ Thus, the most expensive employee for a closely-held business to hire is a family member.⁷ The statute does not make sense. Taxpayers will not trust what they do not understand or what they believe unfairly deprives them of what they are justly due. The result is non-compliance.

The second social policy concern focuses on the premise that the economic basis of the United States is predicated upon the entrepreneurial spirit with its resulting emphasis on the family owned, closely-held corporation and the family farm. This second concern naturally centers on the resulting penalization of transfers of property at death that result in the imposition of large estate taxes. This penalization results from the inclusion of 100% of the appreciated value of the previously transferred assets back into the decedent's estate. Larry C. Raburn, a national director of estate planning for Deloitte, Haskins, & Sells has stated a widely held view that "[i]mposing this tax burden on closely held businesses will probably create severe disincentives for younger generations to continue the family business."⁸ The result would be that "[t]hey may have to sell off too many of the assets to pay the taxes for the business to remain viable."⁹ This result defeats the basic economic principle on which the United States is founded.

The third social policy concern to be dealt with recognizes that statutes must be administered with as much ease as possible. Section 2036(c) falls short. There is ambivalence surrounding the meaning of some of the statute's terminology i.e., "disproportionate share," "enterprise," and "in effect transfers." In fact, some professionals say that "the ambiguous wording of Section 2036(c) creates uncertainties as to what is allowed."¹⁰ As an example, "[t]he definition of enterprise as an 'arrangement rather than a type of property or entity is inconsistent with the statute and the legislative history.'"¹¹ Additionally, the definition of "disproportionate share" is determined by a comparison between two fractions which are in turn based upon the term "potential appreciation." Again the trouble is definitional with the result that the value of the "potential appreciation" limit is ambiguous."¹² Meanwhile, "the section talks about 'enterprise' but does not define what an enterprise is, and it speaks of transferring a 'disproportionate share' without saying how big a share might be disproportionate."¹³ Furthermore, the term "in effect transfers," invokes "considerable uncertainty as to the precise

⁴ S. Stacy Eastland, "The Legacy of I.R.C. Section 2036(c): Saving the Closely Held Business After Congress Made 'Enterprise' a Dirty Word", *Real Property Probate and Trust Journal*, Vol 24, No.3, pg. 259-330 at 278.

⁵ *supra* at 378.

⁶ S. Stacy Eastland, *supra* at 283.

⁷ *supra* at 291.

⁸ Jan M. Rosen, *supra* at 28.

⁹ *supra* at 28.

¹⁰ Jan. M. Rosen, *supra* at 28.

¹¹ Allan Howeth, Lloyd L. Plaine, & Pam H. Schneider, "Section 2036(c): Comment on IRS Notice 89-99, *Probate and Property*, May/June 1990, vol.4, no.3, pg. 39-46 at 42.

¹² S. Stacy Eastland, *supra* at 286.

¹³ Jan M. Rosen, *supra* at 28.

meaning of the overall operative provision in which it appears,"¹⁴ and "the idea of 'in effect transfers' seems broad indeed."¹⁵

The situation is further clouded by added problems of compliance which the taxpayer faces. In order to meet the demands of the statute, while preserving the structure of the family farm and or a family owned closely-held corporation, the taxpayer is confronted with intricate "safe harbor" provisions. These provisions include complicated, and involved valuation formulas, which are accompanied by copious and interpretive regulations. For example, two years after the enactment of the statute, taxpayers still have little guidance as to how to compute the calculations caused by the interrelationship between sections 2036(c) and 2043.¹⁶ Additionally, "[a]nother interesting facet of section 2036(c) that is apparent from the calculation of the tax ... is that Congress has increased the valuation problems with which the Service must deal,"¹⁷ for "[a]lthough the formula looks scientific, it quickly becomes clear that the terms to be inserted in the equation are difficult to ascertain with mathematical precision."¹⁸ Alone, each of these issues is confusing. As a group, they present a formidable barrier to prospect of administrative ease for a statute.

The fourth social policy concern is the necessity of forestalling additional judicial interpretation. This can be accomplished by the use of existing legal precedent which interpret present tax codes and regulations. This would reduce the court's already overburdened case load, and save taxpayers' money by the elimination of wasted time and effort. Finally, and perhaps most important of all, the tax collecting process would not be delayed by long interpretative and adversarial battles. The Federal government would therefore be allowed to gain more quickly its objective of raising money so as to serve the needs of its people.

III. RECOMMENDATIONS FOR REFORM.

Section 2036(a) should be repealed. In its place should be added an addition to Section 2036(a) which reads:

"AND

(1) thirty-five percent (35%) of the value of any appreciated property realized by the transferee(s), if the transferee(s) hold the property for more than three years before the transferor's death and five years afterwards, as based on the net value of the property received by the transferee(s) in excess of consideration paid by the transferee(s) received in money or money's worth^{19 20}, unless:

a. the transferee(s) demonstrate with clear and convincing proof that they had similar abilities, experiences, and contacts so they could have organized a comparable venture and enjoyed a parallel success from their contribution of time, skills, and services so that these factors, coupled

¹⁴ John A. Bogdanski and Lawrence R. Brown, SMPS at 1639,1640.

¹⁵ SMPS at 1639.

¹⁶ S. Stacy Eastland, SMPS at 278.

¹⁷ SMPS at 285.

¹⁸ John A. Bogdanski and Lawrence R. Brown, SMPS at 1645.

¹⁹ United States v. Allen 293 F.2d 916 (10th Cir. 1961), cert. denied, 368 U.S. 944 (1961).

²⁰ Valuation guidelines are found in Treasury Regulations sec. 20.2031-2(f), 25.2512-2(f), 20.2031-3 (estate tax), and 25.2512-3 (gift tax) which may in turn be supplemented by Rev. Rul. 59-60, 1959-1 C.B. 237, sec. 4.01, Rev. Rul. 68-609, 1968-2 C.B. 327, and Rev. Rul. 68-609, 1968-2 C.B. 327.

with the proven capacity of the respective transferee(s), and the value to the business of their contributions²¹ points to full consideration for the property transferred.²²

b. the transfer qualifies as a distribution in redemption of stock within 26 U.S.C. sec. 302(a).

Otherwise, 100% of the appreciated value so transferred will be included in the decedent's estate."

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²¹ In Bechrock v. Commissioner, 7 T.C. 848 (1946).

²² Fed. Reg. 20.2031-2(h). Buy sell agreements must be a "bona fide business agreement and not a device to pass decedent's estate to the natural bounty without full and adequate consideration."